

**TAXATION OF INCOME OF INTERNATIONAL
TRANSPORTATION COMPANIES**

HAKAN UZELTURK

Thesis for the degree of the Ph.D. submitted to the University of Edinburgh

1997



I confirm that this is my own work, has been composed by myself, and does not include work submitted for any other degree or professional qualification.

Dedicated to my mother Nazli Uzelturk
and the memory of my father Mevlut Uzelturk.

ABSTRACT

The thesis is divided into three parts.

Following the introduction, In Part I of the thesis, international double taxation and double taxation treaties are examined. First, emphasis is placed on the character of the international double taxation and how it occurs according to different principles. The historical developments and research on the prevention of international double taxation, with the explanation of different methods in general are also considered. Second, information about double taxation agreements is provided including definitions, functions, types, historical background and the role of international organisations. Third, interpretation of double taxation treaties is reviewed.

In Part II of the thesis, the various problems in the field of taxation of international transportation income are investigated on the basis of the OECD and the United Nations Treaty Model. For example, when the OECD Model Article 8 adopts the residence principle for international transportation profits, the United Nations Model has two different versions of Article 8, Article 8A and Article 8B. Article 8A is as same as the OECD Model Article 8 and uses the residence principle. Alternatively, Article 8B is especially suitable for developing countries because of the source principle. There are two separate principles in Article 8B. The one related to air transportation still uses the residence or domicile principle. The other one applies the source principle to shipping companies.

In Part III of the thesis, certain national systems -- Canada, Turkey, the United Kingdom and the United States -- their position under the United Nations and the OECD Models, and their double taxation agreements with international transportation content are reviewed.

The thesis ends with a conclusion.

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LIST OF ABBREVIATIONS

A.C.	: Appeal Cases, Law Reports, United Kingdom
C.B.	: Cumulative Bulletin, United States
C.I.R.	: Commissioner of Inland Revenue
CCH	: Commerce Clearing House
Ch.D.	: Chancery Division, United Kingdom
CLR	: Canadian Law Review
Cmd.	: Command Paper
Co.	: Company
CTA	: Corporation Tax Act, Turkey
CTC	: Canadian Tax Cases
D.L.R.	: Dominion Law Reports
D.T.C.	: Dominion Tax Cases
Danistay	: Turkish High Court
EFTA	: The European Free Trade Area
ETSC	: European Taxation Section C.
Exch.	: Exchequer
F2d.	: Federal Reporter, 2nd Series, United States
FA	: Finance Act
FAPI	: Foreign Accrual Property Income
GATT	: General Agreement on Tariffs and Trade
H.R.	: House of Representatives
HMSO	: Her Majesty's Stationary Office
ICAO	: International Civil Aviation Organization
I.C.C.	: The International Chamber of Commerce
i.e.	: id est, that is to say
I.R.C.	: Internal Revenue Code, United States
ICTA	: Income and Corporation Act, United Kingdom
IR	: Inland Revenue
IRB	: Internal Revenue Bulletin, United States

IRC	: Internal Revenue Code, United States
IRS	: Inland Revenue Service, United Kingdom
IRS	: Internal Revenue Service, United States
ITA	: Income Tax Act, Canada
L.J.Q.B.	: Law Journal Quarterly Bulletin
LAFTA	: The Latin America Free Trade Area
LR	: Law Report
LTR	: Private Letter Ruling, United States
M	: Mukerrer
M.N.R.	: Minister of National Revenue
NAFTA	: The North America Free Trade Association
O.E.C.D.	: Organization for Economic Cooperation and Development
O.E.E.C.	: Organization for European Economic Cooperation
Rev.	: Revised
RG.	: Resmi Gazete, Turkey
RSC	: Revenue Service of Canada
S.T.C.	: Simon's Tax Cases
SC	: Status of Canada
Sess.	: Session
SI	: Statutory Instrument, United Kingdom
SP	: Statements of Practice, United Kingdom
SR & O	: Statutory Rules and Orders
Stat.	: Statutory
T.C.	: Tax Cases, United Kingdom
T.C.	: Tax Cases, United States
T.D.	: Treasury Department
TIAS	: Treaties and Other International Acts Series
TS	: Treaty Series
TUSIAD	: Turk Sanayici ve Isadamlari Dernegi
UST	: United States Treaties
VAT	: Value Added Tax
VATTR	: VAT Tribunal
www	: World Wide Web

INTRODUCTION

In today's world, international borders are not as rigid as they have been historically. Developments in the area of telecommunication have decreased the importance of national borders. Also the developments of relationships between countries, the establishment of interest groups, and of social, economic and political unions between countries are all positive movements favouring international relationships. Nations benefit economically when their companies work abroad and develop their strength in international markets. Economic power also brings international political power and prestige.

When dealing with international business, taxation is one of the most important problems. Double taxation, which is to tax the same profit by two or more countries, is a serious obstacle that confronts international enterprises. The problem of international double taxation has existed for ages; looking at history, many attempts have been made to prevent this problem in different countries. Unless double taxation is avoided it will be difficult for enterprises to conduct international business profitably. Furthermore, the high rates of tax, a consequence of double taxation, may create an incentive for enterprises to engage in tax evasion¹. Inevitably international transportation business also has double taxation problem due to its nature, because international transportation companies work in international arena.

Naturally countries want to defend their interests against each other and in international relations this causes many problems. Despite all the progress in the field of international taxation, countries are reluctant to relinquish their sovereignty over taxation to any union or group. Also the differences between countries' tax and economic

¹ The Second Report of the OEEC Fiscal Committee of 1959 stated that, by the nature of their business, shipping, inland waterways transport and air transport enterprises are more exposed than most other industrial and commercial enterprises to the danger of multiple taxation on their income, as they are liable to be taxed simultaneously in their own countries and in the other countries where they receive payment for the carriage of passengers or goods or where their activities are exercised.

systems affect the problem of double taxation. For example, if country A uses the residence principle, namely that the country of residence has a right to tax the company's income wherever income arises², and if country B uses the source principle³, namely that the country of source of income has a right to tax, then the income of a company that has a residence in country A but which was realised in country B, is subject to international double taxation. Under this condition the company is under obligation to pay tax twice, or is pressured to place either its residence or its business in another country.

Certain methods exist to prevent international double taxation. Although countries adopt some rules in their tax systems unilaterally, generally countries prefer to make double taxation agreements. A multilateral treaty is another method where more than two countries are concerned. Since many countries sign the same agreement it will facilitate the application of the same rules to the problems. Also multilateral treaties are said to encourage the harmonisation of different tax systems that exist across countries. Although a couple of multilateral treaty attempts have been made, only one of them, the Nordic Pact⁴, is still in use. The reason for its success is the economic and political similarity between the Nordic Countries.

Without the existence of a general multilateral tax treaty, in practice countries use bilateral tax treaties to prevent international double taxation. They are easier to establish than multilateral agreements because of the number of treaty partners. Also, bilateral agreements are flexible with regard to new developments after the treaty is signed. Although the time for negotiations is shorter than for multilateral treaties, still double taxation agreements are adopted through a long process of negotiations. The similar or same economic structure and close political relationships between two countries can help to make the negotiation process shorter. Cultural and historical similarities between two countries also help international double taxation agreements to be effective. Also, new developments after the signing of treaty will cause new double taxation problems and, again, countries must solve those differences via negotiations.

Under a double taxation agreement two countries reach an agreement to use either the residence, source or another principle, such as the effective management principle. The developed countries naturally tend to exploit their advantage or power

² *Infra*, p.10.

³ *Infra*, p.11.

⁴ *Infra*, p.31.

over developing countries by using the residence principle. When developed countries use the residence principle they maintain the right to tax, increasing their own tax revenues. On the other hand, developing countries want to use the source principle that gives them an advantage to advance their economic developments and increase their tax revenues, which will be helpful for future investment. Under these circumstances, each country tries to maximise its revenues. This is true even among developing countries themselves, which prefer the residence principle in agreements between each other.

Different international organisations have studied the problem of double taxation and produced models and ideas. After many years of experience, and of both research and discussions, various Model Conventions have been produced about bilateral tax treaties. If the agreement is based on a Model, such as the OECD or United Nations Model, agreement is much easier to establish because of the practice and experiences of other countries.

Beside the OECD and the United Nations, other international organisations also produced several ideas and gave important support to the solutions of certain problems⁵. For example, the League of Nations, the forerunner of the United Nations, played a leading role in this area. The most popular ones are the OECD and the United Nations Model Tax Conventions. When countries negotiate double taxation agreements, generally they use Article 8 of the OECD Model or the United Nations Model governs international transportation⁶.

The OECD Model is especially preferred by developed countries because of its use of the residence principle, that gives a significant advantage to developed countries over developing countries. On the other hand, the United Nations Model is preferred by developing countries, because the article applicable to international transportation profits has two different versions to answer the needs of developing countries.

In the field of international transportation one immediately faces a number of problems⁷, one of which is the definition of the term "international transport", as well as the definition of the "profit" arising from international transportation. Since international transportation is, by nature, spread out over more than one and possibly several countries and the enterprises which operate in this area have agencies, ticket sales

⁵ *Infra.*, p.31.

⁶ *Infra.*, p.88.

⁷ *Infra.*, p.64.

bureaux, warehouses, advice bureaux, management sites, hotels, bars, restaurants etc. in various countries. The identification and taxation of those profits is problematic.

Another important source of difficulty lies in the interpretation of treaties. When the terms in international double taxation agreements are not clear, uncertainties are created. This affects countries' tax revenues, because , two different interpretations are possible. The conflict between countries regarding the lack or existence of an obligation can translate into extremely large amounts of money.

In practice some guidelines are used, such as the Vienna Convention on the Law of Treaties⁸. Also, some schools of thought offer liberal, strict or teleological interpretation to find the real meaning of the terms⁹. In general, courts have tended to use a liberal interpretation, in order to find the countries' intention concerning the relevant articles or terms. However, in some cases the strict interpretation has been used which is based on the meaning of the words used in the main text.

The following questions demonstrate how many different problems arise from international transportation activities that countries try to find solutions¹⁰:

1. What is the definition of international transportation?
2. What is the source of income in international transportation?
3. Which incomes are international transportation income?
4. Does international transportation income include income from ancillary activities?
5. How do the principles that determine the tax jurisdiction affect the taxation of international transportation income?
6. What are the problems of companies doing business in the field of international transportation?

⁸ *Infra*, p.40.

⁹ *Infra*, p.53.

¹⁰ *Infra*, p.64.

7. How is it possible to allocate the income from international transportation between different tax jurisdictions?
8. What kinds of rules are used by countries for taxation of international transportation income?
9. What is the position of international leasing? Is this within the context of international transportation?
10. What are the tax problems related to shipping companies that fly flags-of-convenience?

One example serves to illustrate how complicated these problems can be. The starting point of transportation, the end point, the embarkation or disembarkation points during transportation, and the ticket selling points are some of the many possibilities regarding determination of the source of income. As for example, when a person goes from London to Brussels first, then Brussels to New York on different airlines having his ticket in Paris, the allocation of income is problematic. The variety of possibilities make the problem worse.

When examining the national legislation of countries it is also possible to see different problems regarding international transportation. In Canada, for example, to find the meaning of the term "Canadian source income", first one must ascertain the meaning of "carrying on business in Canada", then identify what kind of criteria to be subject to Canadian Income Tax. Also the terms "permanent establishment", "in Canada", "international traffic", "resident", "central management and control", "income earned" can cause problems of definition¹¹. Furthermore, the "gross revenue test" is another area in which problems arise.

In Turkey, despite the fact that the system¹² for international transportation alleviates the difficulty¹³ of discovering the foreign companies' actual income and expenses, still some problems exist. For example, to find the Turkish-source income is quite complicated regarding different routes. The allocation of income between different

¹¹ *Infra*, p.116.

¹² *Infra*, p.171.

¹³ *Infra*, p.177.

transportation companies is also problematic. If the same transportation company uses different vehicles for different routes, it makes it difficult to find the actual income and expenses of the transportation company.

In the United Kingdom, the problems mostly surround the issue of residence¹⁴. In the absence of a statutory definition of the term "resident", case law gains importance. Other important terms to determine are "central management and control" and "carrying on trade or business". Furthermore, finding the residence of dual resident companies that are subject to taxation in two jurisdictions is another problem. The place of effective management is a tie-breaker clause for companies in the OECD Model to determine the residence of the dual resident company. The 1988 changes regarding incorporation rules are especially important in terms of company residence in the United Kingdom.

In the United States, the Internal Revenue Code of 1986 replaced the Internal Revenue Code of 1954. The changes made in the later Code are especially important for foreign corporations operating in international traffic. With the 1986 Tax Reform¹⁵, the reduction of applicable reciprocal exemptions are based on residence instead of flag or documentation of vessel, 4 per cent gross basis tax¹⁶ is imposed for international transportation companies and 50 per cent source rule for transportation that begins or ends in the United States is imposed. Since the existing system before 1986 was easily manipulated by transport companies the new system has increased the United States' income from international transportation.

However, like other countries, some definitions related to international transportation are not clear in the United States tax system. For example, the definition of the "United States source gross transportation income" was not clear until Revenue Procedure 91-12 was adopted. Some other definitions, such as "transportation income" and "resident", still cause problems. Also allocation of income is problematic, especially regarding round-trip travel. Another problem area is the "look-through rule" regarding the 50 per cent rule. Furthermore, the absence of effective penalties for international transportation companies that fail to file tax returns is another weakness of the system.

¹⁴ *Infra.*, p.198.

¹⁵ *Infra.*, p.230.

¹⁶ *Infra.*, p.240.

The main purpose of this thesis try to find an answer that what kind of a solution is sufficient to solve all the problems mentioned above. Since many countries use double taxation treaties as a solution, could a multilateral treaty be established?. Because most of the countries use two Models - the United Nations and the OECD Models - and in their bilateral agreements they have many similarities about taxation of international transportation income. These similarities could lead to a common solution, a multilateral tax treaty.

To find these similarities, the double taxation agreements of four sample countries regarding international transportation have been reviewed. Also, four sample countries' taxation methods on international transportation is searched at the national level. After that some suggestions have been made such as a definition of international transportation¹⁷. This could be within the text of a multilateral tax treaty. Also, some common points are founded to clarify some terms such as "carrying on business"¹⁸.

In Part I of the thesis, international double taxation and double taxation treaties are examined. First, emphasis is placed on the character of the international double taxation and how it occurs according to different principles. The historical developments and research on the prevention of international double taxation, with the explanation of different methods in general are also considered. Second, information about double taxation agreements is provided including definitions, functions, types, historical background and the role of international organisations. Third, interpretation of double taxation treaties is reviewed.

In Part II of the thesis, the various problems in the field of taxation of international transportation income are investigated on the basis of the OECD and the United Nations Treaty Model. For example, when the OECD Model Article 8 adopts the residence principle for international transportation profits, the United Nations Model has two different versions of Article 8, Article 8A and Article 8B. Article 8A is as same as the OECD Model Article 8 and uses the residence principle. Alternatively, Article 8B is especially suitable for developing countries because of the source principle. There are

¹⁷ *Infra.*, p.111.

¹⁸ *Infra.*, p.292.

two separate principles in Article 8B. The one related to air transportation still uses the residence or domicile principle. The other one applies the source principle to shipping companies.

In Part III of the thesis, certain national systems -- Canada, Turkey, the United Kingdom and the United States -- their position under the United Nations and the OECD Models, and their double taxation agreements with international transportation content are reviewed.

PART I: THE PREVENTION OF INTERNATIONAL DOUBLE TAXATION AND INTERPRETATION OF DOUBLE TAXATION TREATIES

CHAPTER I: THE PREVENTION OF INTERNATIONAL DOUBLE TAXATION

1- THE PHENOMENON OF INTERNATIONAL DOUBLE TAXATION

a- Introduction

International double taxation¹⁹ is the phenomenon of a profit being subjected to more than one charge to tax because that one and the same profit would be liable to be taxed by two or more countries. The problem especially increased with developments in the field of international trade and progress of relations between countries.

Dual residence for example, can give rise to international double taxation, since the same taxpayer is resident in two or more countries at the same time for tax purposes²⁰. In this case when two countries use the residence principle, the taxpayer will be subject to tax twice.

Another common situation in which double taxation arises is where the taxpayer is resident in one country and the source of its income is located in another country.

¹⁹ International double taxation is used in this thesis to cover international juridical double taxation. International economic double taxation is not within the context of this thesis. For details see, Manuel Pires, *International Juridical Double Taxation of Income*, Kluwer, Deventer-1989, pp.55-62; Klaus Vogel, *Double Taxation Conventions*, Kluwer, Deventer-1991, pp.2-3.

²⁰ J. D. R. Adams - J. Walley, *The International Taxation of Multinational Enterprises in Developed Countries*, The Institute For Fiscal Studies, London-1977, pp.41-44; David Tillinghast, *International Economic Law*, Volume 5 - Tax Aspects of International Transactions, Matthew Bender, United States-1984, p.6.

When two countries tax the same company due to its residence and source of its income respectively, international double taxation also arises.

Also another frequent source of international double taxation is the computation of profit. Even if two countries have the same rules, the interpretation of the terms may lead to international double taxation²¹.

When countries wish to tax profits from international transportation which have been spread out over a multitude of States they use a direct taxation method. In the field of international taxation, three fundamental concepts of direct taxation exist²²:

- the residence or domicile principle
- the source or *situs* principle
- the nationality or citizenship principle.

Between these three principles a hybrid alternative has been adopted in some model treaties: this is the "place of effective management" principle²³. All these principles can be found in double taxation agreements almost unchanged from the beginning²⁴.

²¹ *Infra.*, p.36.

²² The United Nations Manual for the Negotiation of Bilateral Tax Treaties Between Developed and Developing Countries, New York, 1979, p.11 (Hereinafter referred as the UN Manual); David R. Tillinghast, *Tax Aspects of International Transactions*, Matthew Bender, New York-1978, pp.1-7; Honey Lynn Goldberg, "Conventions for the Elimination of International Double Taxation: Toward a Developing Country Model", *Law & Policy in International Business*, Vol.15(1983), pp.839-840; Justus Fischer-Zernin: GATT Versus Tax Treaties? The Basic Conflicts Between International Taxation Methods and the Rules and Concepts of GATT, *Journal of World Trade Law*, 1987/3, pp.47-48; Roberto D. Klock: "The Role of the United States Income Tax Treaties: Two Spheres of Negotiations", *Texas International Law Journal*, Vol.13(1978), p.378; Stanley Surrey: "United Nations Group of Experts and the Guidelines for Tax Treaties Between Developed and Developing Countries", *Harvard International Law Journal*, Vol.19(1978), No.1, pp.19-20.

²³ *Infra.*, p.79.

²⁴ *Infra.*, p.65..

The first principle, the residence principle²⁵, permits a state to tax the income of its residents regardless of the territorial source of their income. The term "resident of a Contracting State", used in some model agreements, means any person who, under the laws of that State, is liable to tax therein by reason of his residence, domicile, place of management or any other criterion of a similar nature²⁶.

The second principle, but one which is less often utilized in practice, is the source principle: taxation is linked not to the place of residence or the nationality of the taxpayer but to the source of income. A country taxes income earned from sources within its geographical territory.

The base for the international transportation profits are carrying passengers or freight in the international area between stoppage points. In practice, the source principle may not be appropriate since the profits have not been obtained when the passengers and freight are loaded²⁷. It is possible to argue that the profits are earned on the completion of the journey and so the source of the profit is the place where the journey is terminated.

In some circumstances, such as when a ship goes to a port and has loaded or unloaded its freight and then goes to another port in another country, the country where the port in which the loading or unloading activities took place will have a right to tax the profits from this transportation under the source principle.

In fact, to spend a few hours in a port would give the right to tax to the country in which the port is situated under the source principle. In this case, the country of residence or the country of effective management would not have a right to tax those profits from international transportation. This possibility does not seem fair for the latter countries.

In relation to the taxation of profits from international air transportation, developing countries considered that the geographical source of profits from international air transportation should be the place where passengers or freight were booked, because the use of the residence principle gives insufficient consideration to the

²⁵ Since fiscal domicile is usually defined in terms of residence, no distinction is normally made between residence and domicile in international tax law (Picciotto, op. cit., p.23).

²⁶ The OECD Model, Article-4.

²⁷ Goldberg, op. cit., p.840, footnote-18.

very substantial expenditure that developing countries incurred in the construction of airports²⁸.

However, in practice this has proved difficult since developed countries use their economic and political power to oppose the use of the source principle by developing countries. Although certain representatives from developed countries think that the source principle is acceptable²⁹ for developed countries, this view has not often been translated into practice.

Today most of the countries use the source principle, some with a combination of other principles. However, some countries such as Argentina, the Dominican Republic, Haiti, Panama and Venezuela use only the source principle³⁰.

The third principle is the nationality principle. Under the nationality principle the country has a right to tax its citizens' income, from wherever this is derived.

Only a few countries such as Mexico, the Philippines and the United States³¹ use the nationality principle together with the source and residence principles³².

b- Definition

The definition of international double taxation by the Organisation for Economic Co-operation and Development³³ has a general acceptance as follows:

"The imposition of comparable taxes in two or more States on the same taxpayer concerning the same subject-matter and for identical periods."³⁴

²⁸ The Guidelines for the Formulation of the Provisions of a Bilateral Tax Treaty Between a Developing Country and a Developed Country (Herein referred as the Guidelines) in the United Nations Manual, p.61.

²⁹ The Guidelines, p.60.

³⁰ The UN Manual, op. cit., p.11.

³¹ *Cook v. Tait* (1924), 265 U.S. 47; See, James C. Redmont: "The Unitary System of Taxation- Identification of the Source of Income", *Bulletin for International Fiscal Documentation*, 1981, pp.99-107; Joseph Isenbergh, *International Taxation: U.S. Taxation of Foreign Taxpayers and Foreign Income*, U.S.A. -1990, p.15; H.A. Kogels: "Unitary Taxation: An International Approach", *Bulletin for International Fiscal Documentation*, 1983, pp.65-68.

³² The UN Manual, op. cit., p.11.

³³ Hereinafter cited as the OECD.

c- Historical Background

The problem of double taxation is as old as taxes themselves³⁵. For example in the 5th century BC, the inhabitants of Oponete and other cities in Eastern Locrida founded a colony in Naupakta, in Western Locrida. The inhabitants were taxed locally and were exempted from taxation in their homeland³⁶.

In the 13th Century, after the establishment of property taxes both in France and Italy, a person who had a property in one of the above countries and a residence in the other country, was taxed twice, once by his country of residence and once by the country where the property was situated³⁷ and the exemption method³⁸ was used to solve the double taxation problem.

In the middle ages canonists, glossarists and theologians worked on double taxation. For theologians it was a matter of justice and ethics³⁹. In the 14th century, Guilherme de Cuneo, Pedro de Ubaldis, Oldradus de Lodi, Joao Andre and Antibolus were among the people working in the field of international double taxation and residence theories. In the 15th century, Joao Bertachino claimed that foreigners should not be liable to personal taxes⁴⁰.

³⁴ The Report of the OECD Fiscal Committee, Model Convention of the OECD for the Avoidance of Double Taxation with Respect to Taxes on Income and Capital, OECD Document No. C.(63)87, 1963 para.3; The Report of the OECD Committee on Fiscal Affairs, Model Double Taxation Convention on Income and Capital, 1977, OECD Publication No.2277011, para.3; The Report of the OECD Committee on Fiscal Affairs, The OECD Model Tax Convention on Income and Capital 1992, para.3. For the causes of international double taxation see: Rutsel Silvestre J. Martha, *The Jurisdiction to Tax in International Law*, Kluwer, Deventer-1989, pp.141-180.

³⁵ Pires, op. cit., p.93.

³⁶ Idem.

³⁷ Edwin R. A. Seligman, *Double Taxation and International Fiscal Cooperation*, The Macmillan Co., New York-1928, p.32.

³⁸ Infra., p.15.

³⁹ Pires, op. cit., p.93.

⁴⁰ Idem.

In the following centuries, international double taxation was an important problem: in the 16th and 17th century, introduction of general taxation on capital in the German principalities was a concern and in the 18th century, inheritance taxes on the assets of foreigners⁴¹ was an issue. In the 19th and 20th century the problem of international double taxation developed very quickly given increasing relationships between countries.

2- THE WAYS TO PREVENT INTERNATIONAL DOUBLE TAXATION

There are three main ways to prevent international double taxation: unilaterally at the national level and bilaterally and multilaterally at the international level.

a - Unilaterally

Some countries make provisions in their domestic taxing legislation for prevention of double taxation. They exempt certain foreign activities from tax or provide credit to the taxpayer in his country of residence for the taxes paid by the taxpayer in the investment country. This form of relief from double taxation is referred to as unilateral relief, and may completely solve the problem of double taxation⁴².

Early examples of this can be found in the context of international transport. In 1819, a Dutch law was passed whereby exemption from the payment of a licence tax to foreign ships was granted, subject to reciprocity for Dutch ships⁴³.

In the period from 1921-1923, the United States and Great Britain established provisions exempting profits earned from running ships subject to foreign laws from taxation; the Netherlands and Japan followed this example adding the condition of reciprocity⁴⁴.

⁴¹ Idem.

⁴² Philip Baker, *Double Taxation Agreements*, Key Haven Publications Limited, London-1990, p.1.(Herein after referred to as the Baker. 1990); Adams - Whalley, op. cit., p.44.

⁴³ J. G. Herndon, *Relief from International Income Taxation*, Callaghan, Chicago-1932; Pires, op. cit. p.95.

⁴⁴ Pires, op.cit., p.95; See, J.D.B. Oliver. "Unilateral Relief: The Issues in *Yates v. GCA*", *British Tax Review*, 1993, p.205.

However, in practice, the unilateral method is not appropriate because, in the host country it has a limited effect and specific tax holidays⁴⁵ and fiscal incentives have not been taken into account⁴⁶.

b - Bilaterally

Double taxation agreements⁴⁷, however, provide relief from double taxation where there is no unilateral relief or where the unilateral relief provides an incomplete solution. Relief from double taxation in the form of a treaty is generally referred to as bilateral or treaty relief. Treaties generally apply either to income and capital taxes, or to estate and inheritance taxes.

The two main methods⁴⁸ generally in use are the exemption and credit methods⁴⁹.

ba- Exemption method

In the exemption method, one of the contracting states is granted the exclusive right to tax certain items of income; this income is then exempted from tax in the other. The profit may be exempt from tax in the state of source or exempt from tax in the state where the recipient resides⁵⁰. The exemption may be either "full exemption" or "exemption with progression"⁵¹.

⁴⁵ *Infra*, p.20.

⁴⁶ Francisco Dornelles: "The Relevance of Double Taxation Treaties for Developing Countries", *Bulletin for International Fiscal Documentation*, August/September-1989, pp.384.

⁴⁷ *Infra*, p.22.

⁴⁸ For details see, Pires., *op. cit.*, pp.170-171, footnote-10 and Julie A. Roin: "The Grand Illusion: A Neutral System for the Taxation of International Transactions", *Virginia Law Review*, Vol.75(1989), No.5, pp.923-927; Julie A. Roin: "Rethinking Tax Treaties in a Strategic World with Disparate Tax Systems", *Virginia Law Review*, Vol.81(1995), No.7, pp.1781-1783. Although, in practice, some other methods exist, in this part only the general framework is given. Further details of the other methods are not discussed since they are not directly within the context of this thesis.

⁴⁹ Dornelles, *op. cit.*, pp.385-386.

⁵⁰ The OECD Model, Article 23A(2).

⁵¹ Pires has classified the exemption method as conditional or unconditional and full or with progression, *op. cit.*, p.174.

baa- Full Exemption

By this method income which may be taxed in the source country is totally excluded from the tax base of the taxpayer in his country of residence or vice versa. If the income from an overseas source is exempted in the country of residence this provides an advantage for source countries, in that they keep tax revenues from operations conducted within their borders.

bab- Exemption with progression

Although, as with full exemption, the income from the country of source is not taxed in the country of residence, it is taken into account for the purposes of working out the rate of tax to be charged in the country of residence.

The system is applied through a bilateral tax treaty⁵², and has been used in treaties concluded by Austria, Belgium, Germany, Finland, France, Iceland, Luxembourg, the Netherlands, Spain and Switzerland⁵³.

The following is an example to illustrate the full exemption and exemption with progression method⁵⁴:

Total income is 100,000 of which 80,000 is derived from the state of residence and 20,000 from the state of source. The rate of tax in the State of residence on an income of 100,000 is 35 percent and on an income of 80,000 is 30 percent. The rate of tax on an income of 20,000 in the state of source is 20 percent.

If the taxpayer has all this income of 100,000 in the state of residence, his tax is 35,000. If he derives 80,000 of his income in the state of residence and 20,000 of his income in the state of source, in the absence of any domestic relief in the state of residence and/or conventions between the state of residence and the state of source, the taxpayer is going to pay $35,000 + 4,000 = 39,000$.

Under the exemption method, the taxpayer is subject to tax on his income of 80,000. Under the full exemption method, the taxpayer's 80,000 income is subject to tax at 30 percent in the state of residence. The taxpayer is going to pay $24,000 + 4,000 = 28,000$.

⁵² The OECD Model, Article 24(1).

⁵³ The UN Manual, op. cit., p.13.

⁵⁴ The OECD Model Commentary on Article 23, paragraphs 18-20.

Under the exemption with progression method, the taxpayer's 80,000 income is taxed at 35 percent, that is the rate of tax applicable to total income wherever it arises (100,000), in the state of residence. The taxpayer is going to pay $28,000 + 4,000 = 32,000$.

bb- Credit method

Under the credit method⁵⁵, each of the contracting states levies taxes, but the country of residence permits taxes that are paid to the source country to be deducted from its own taxes, with certain exceptions.

bba- Full credit

Under the full credit method, the taxpayer claims the credit without any limitation. The country of residence deducts income taxes paid to the source country from its own income taxes.

The following is an example to illustrate the credit method⁵⁶:

All the figures are as same as in the example of the exemption method⁵⁷. Under full credit method, taxpayer's total income of 100,000 is subject to tax at the rate of 35 percent before relief. The tax is paid by the taxpayer on his income in the state of source namely 4,000. The taxpayer is going to pay $35,000 - 4,000 = 31,000$ to his state of residence.

bbb- Ordinary credit

If the credit is subject to certain limits, it is called the ordinary credit method⁵⁸. These limits are either based on the world-wide income of the taxpayer or on income derived from each foreign country. The first one is called "overall limitation" and second one is called "per country limitation". The ordinary credit method is the method adopted in the OECD Model Convention⁵⁹.

⁵⁵ Also referred to as a imputation or deduction method.

⁵⁶ The OECD Model Commentary, Article 23, para. 23.

⁵⁷ Supra., p.15.

⁵⁸ Or normal credit. The ordinary credit is also categorized by Pires: 1- Effective or direct credit - Proportional credit, 2- Global credit (limited or unlimited) - Special credit, for details see, Pires, op. cit., pp.186-187, footnote-45.

⁵⁹ The OECD 1992 Model, Article 23B(1).

If the foreign tax rate is lower than the domestic rate, only the difference between the domestic tax and foreign tax is payable to the investor's country of residence. If the foreign tax is higher than the domestic tax, the taxpayer need not pay any tax in the country of residence. In this context the definition of taxable income is important. It can be different in the two countries, in which case there will be differences between the country of residence and the country of source in the amount of the taxpayer income that is subject to tax⁶⁰.

Under the ordinary credit method, the main difference from the situation above is the existence of a maximum deduction in the state of residence. The maximum deduction in this case would be 35 percent of 20,000 = 7,000. Assume that tax rate in the state of source is 40 percent and the tax payable on 20,000 is 8,000. In this circumstance the maximum deduction in the state of residence is 7,000 instead of 8,000. The taxpayer is going to pay $35,000 - 7,000 = 28,000$.

cc- Other mechanisms

Also, other mechanisms can be used in bilateral taxation agreements⁶¹. These are:

- Tax deferral
- Investment credit
- Matching credit
- Tax sparing credit mechanisms.

cca- Tax deferral

The taxpayer does not pay tax in his country of residence until he effectively receives his foreign source income. For this reason the taxpayer may prefer to keep his

⁶⁰ The United Nations Manual, op. cit., pp.13-14.

⁶¹ Dornelles, op. cit., pp.386-388.

income in the source country to invest instead of paying tax in his country of residence on his foreign source income. Tax deferral is also good for developing countries as it encompasses investing to keep capital inside the source country.

ccb- Investment credit

Under this system only a percentage of the returns from investment will be taxed in the taxpayer's country of residence. Providing investment credit is also helpful for the developing countries to attract foreign investors.

ccc- Matching credit

The matching tax credit is more or less functionally equivalent to exemption by the country of residence. The way in which this works is the country of residence grants a credit equivalent to the rate of tax applicable in the country of residence, rather than the tax actually paid in the country of source. For example, the credit rate is 25 per cent in the country of residence and 15 per cent in the country of source.

Under normal tax credit arrangements there could be an additional 10 per cent tax to pay in the country of residence. Under the matching credit there is no further liability. Matching credit can even apply when the rate of tax in the country of source is 0 per cent.

This system is also beneficial for developing countries. They can change the rates to attract the investors or completely eliminate the rates. The developing country has an opportunity to impose its system with flexibility according to its needs.

ccd- Tax sparing credit

Tax-sparing credit is another method that is used by developed countries in their treaties with developing countries. This idea was developed in the 1950s. Under the tax sparing credit method a developed country would agree by treaty to give a credit not only for taxes imposed by a developing country but for taxes that would have been imposed without tax holiday legislation⁶².

⁶² H. David Rosenbloom - Stanley I. Langbein: "United States Tax Treaty Policy: An Overview", *Columbia Journal of Transnational Law*, Vol.19(1981), No.3, pp.45-46.

The term "tax holiday" means a period of exemption from income tax for new industries, granted by developing countries in order to develop or diversify their industries⁶³.

The tax sparing method is explained in the United Nations Manual⁶⁴, as follows:

"... the country of residence grants a tax credit calculated at a higher rate than the tax currently applied in the source country. In certain instances, the country of residence grants a credit not only for the tax actually paid in the developing country but also for the tax spared by incentive legislation in that country, that is, the tax that would have been paid to the developing country had it not reduced its income taxes with a view to providing tax incentives for foreign investors.

Tax sparing clauses have been included by most of the major capital-exporting countries (e.g., Canada, France, The Federal Republic of Germany, Japan and the United Kingdom of Great Britain and Northern Ireland) and developing countries. However, the United States treaties do not incorporate tax-sparing clauses, the reason being that the standard of "capital export neutrality" should be applied to the taxation of foreign investment and that investment in developing countries can be appropriately encouraged by direct subsidies rather than by indirect tax incentives."

The tax sparing method is also referred to, in error, as the "matching credit method" in practice⁶⁵. Despite the fact that these two methods are quite similar, a significant difference between them exists. Under the matching credit method the credit rate in the residence country is previously established in the treaty. Under the tax sparing

⁶³ International Bureau of Fiscal Documentation (Editor Susan M. Lyons), *International Tax Glossary*, IBFD Publications BV, Amsterdam-1992, p.244.

⁶⁴ The UN Manual, op. cit., p.15.

⁶⁵ Pires, op. cit., p.188.

method the credit rate is contingent on the prevailing rate in the source country. If there is a reduction in tax rates the amount of credit may decrease⁶⁶.

c - Multilaterally

The system is the same as with bilateral methods, with the difference that more than two countries are involved. The preparation of the treaty and negotiations are more complex and lengthy.

⁶⁶ Dornelles, op. cit., p.387.

CHAPTER II - DOUBLE TAXATION TREATIES

1 - DEFINITION

A double taxation agreement is an international tax treaty concluded between two or more states to regulate the exercise of tax jurisdiction by the two states for the elimination or reduction of international double taxation⁶⁷.

Although most OECD members⁶⁸ use the OECD Model, some members of the OECD -- for example the United States⁶⁹ and the Netherlands⁷⁰ -- have developed their own models. These models are based largely on the OECD Model.

Incorporation of double taxation treaties into domestic law is sometimes automatic as in the United States and France. In the United Kingdom, the treaty has to be expressly incorporated into domestic law by enactment of an Order in Council under S.788 ICTA-1988⁷¹.

2- NAMES

Double taxation treaties are variously referred to as agreements, arrangements, conventions or treaties. A technical distinction found in the United Kingdom which does not have any practical significance is that double taxation *arrangements* are entered into with dependent territories where the Crown is responsible for the foreign affairs of that

⁶⁷ Baker: 1990, p.1.

⁶⁸ Australia, Austria, Belgium, Canada, Denmark, Germany, Finland, France, Greece, Iceland, Ireland, Italy, Japan, Luxemburg, The Netherlands, New Zealand, Norway, Portugal, Spain, Switzerland, Turkey, the United Kingdom and the United States.

⁶⁹ H. Shannon: "Comparison of the OECD and US Model Treaties for the Avoidance of Double Taxation", *International Tax Journal*, Vol.12(1986), p.265; Kees van Raad, *Model Income Tax Treaties*, Kluwer, Deventer-1983; Estes, op. cit., p.509.

⁷⁰ The United Nations Document, ST/ESA/102, New York, 1980; International Fiscal Association, Congress Seminar Series, No. 4: The United Nations Draft Model Tax Convention, Deventer, 1979.

⁷¹ Baker:1990, pp. 2 and 21.

territory, *agreements* are entered into with Commonwealth countries where the Queen is head of state and *conventions* are entered into with all other countries⁷².

The words "agreement", "treaty" and "convention" will be used interchangeably in this thesis.

3- FUNCTIONS

Double taxation agreements have many functions as well as relief of double taxation⁷³. These are:

- a- eliminating double taxation in order to prevent the discouragement of international trade;
- b- providing for co-operation between tax administrations to combat tax evasion;
- c- providing certainty as to the tax regime faced by investors and trades - again to prevent discouragement of international trade;
- d- the elimination of discriminatory taxation;
- e- the sharing of tax revenue.

Under tax treaties treaty partners can receive information about taxpayers and their activities that is very useful in the prevention of international tax evasion. Another possibility afforded by tax treaties is that the two treaty partners can discuss each others' tax problems with a view to improving their tax systems.

The purpose of double taxation conventions has been stated in the United Nations Model as follows⁷⁴:

"Broadly, the general objectives of bilateral tax conventions may today be seen to include the full protection of taxpayers against double

⁷² Ibid., p.1.

⁷³ Philip Baker, *Double Taxation Conventions and International Tax Law*, Sweet & Maxwell, London-1994, p.12 (Hereinafter referred as Baker:94); Estes, op. cit., pp.508-509; See, R.D. Brown: "Canada's Expanding Tax Treaty Network and the Channelling of International Investments", *Canadian Tax Journal*, Vol.25(1977), pp.638-639.

⁷⁴ The United Nations Model, op. cit., p.1.

taxation (whether direct or indirect) and the prevention of the discouragement which taxation may provide for the free flow of international trade and investment and the transfer of technology. They also aim to prevent discrimination between taxpayers in the international field, and to provide a reasonable element of legal and fiscal certainty as a framework within which international operations can be carried on...In addition the treaties have as an object the improvement of co-operation between tax authorities in carrying out their duties."

4- TYPES

In general two types of double taxation treaties exist: bilateral and multilateral treaties⁷⁵. Although double taxation treaties cover two main areas of taxation: estate taxes and income taxes, this thesis is concerned solely with income tax treaties.

a - Bilateral Treaties

A bilateral tax treaty is one made between two countries mainly⁷⁶ to modify the double taxation that would otherwise arise under their domestic tax provisions⁷⁷.

The advantages of a bilateral tax treaty are:

⁷⁵ However, Baker mentions 24 different classifications such as, treaties on income and treaties on inheritance, estates and gifts, comprehensive and limited agreements, bilateral and multilateral conventions, administrative assistance and ancillary conventions, Baker:94, p.13.

⁷⁶ Supra., p.22.

⁷⁷ Adams - Whalley, op. cit., p.44.

1- They are very practical because, being between only two countries, they are easier to establish than multilateral treaties and can effectively prevent or eliminate double taxation and its effects.

2- Another advantage is that bilateral treaties are easier to change than multilateral agreements⁷⁸, because only two parties are involved.

3- Bilateral treaties are generally helpful, for the security of business between countries. The Fiscal Committee of the OECD stated in 1965 that⁷⁹:

"...apart from the solution of concrete tax problems relating to international trade and investment, tax conventions (for the prevention or elimination of double taxation) can provide an improvement in the general tax atmosphere by offering re-assurance to investors and businessmen that there exists a mechanism for the settlement of tax grievances that may arise.

The mere fact of a tax treaty having been agreed to, even if it provides no formal procedures for the settlement of differences, conveys a sense of co-operation between the authorities of the two countries which instils confidence that potential disputes can be settled on reasonable terms. In addition, however, tax treaties may provide authorisation for specific procedures, for mutual agreement in the settlement of differences."

The main disadvantage of the bilateral agreements is that they must be negotiated separately, which results in a proliferation of treaties.

⁷⁸ Pires, op. cit., pp.243-244.

⁷⁹ The OECD, Fiscal Incentives for Private Investment in Developing Countries, Report of the Fiscal Committee, Paris-1965, para.166, OECD Publication No.2365011.

Bilateral rather than multilateral treaties are likely to remain the norm for the time being because of the difficulties arising from the various permutations produced by different tax systems and the more complex processes of drafting and negotiation when several countries are involved⁸⁰.

b - Multilateral Treaties

Multilateral treaties are between more than two countries, but essentially the same system applies as in bilateral treaties. International organisations and groups of individual countries have considered the development and implementation of multilateral treaties, but such treaties have only been realised in the field of administrative assistance and exchange of information.

The advantages of a multilateral tax convention are:

- 1- A multilateral convention provides uniformity for double taxation treaties.
- 2- Its tendency to encourage more towards uniformity in national tax systems.

3- The problems arising from the application of a multilateral convention can be solved easily within the context of the agreement. Otherwise, when these countries have a tax problem with a country other than that which signed the multilateral convention, the existence of many double taxation agreements cause difficulties for the solution.

However, multilateral conventions have some disadvantages. First, it is very difficult to co-ordinate the interests, in the field of economy, tax or politics, of various countries. The negotiations between only two countries take a very long time. For this reason it is more difficult to make progress negotiating multilateral conventions between more than two countries, because of the complexity of their tax systems and their intention to use their sovereignty for the collection of tax.

Even if, despite all difficulties, a multilateral convention is signed, the potential dissatisfaction is greater than where bilateral treaties are used. After signing a multilateral

⁸⁰ Baker: 1990, p.2, p.59.

convention, countries can face many problems as well. Changing and interpreting some parts of the convention for a common solution require the support of many countries that possibly will oppose proposed changes in the light of complex international relations.

No multilateral convention has been realised between the major economic powers of the world, because of the complexities⁸¹ of the various interests involved. Negotiating such a convention between similar countries or economic groups is the only viable option⁸².

5- HISTORICAL BACKGROUND

a- Generally

aa - Bilateral Treaties

The first agreement in the field of international taxation was signed between Belgium and France in 1843 on the exchange of information and documents between French and Belgian tax collectors. In 1845 two agreements were signed between Belgium and the Netherlands and Belgium and Luxembourg. All of these were concerned with tax assistance⁸³.

Conventions were entered into between Prussia and Saxony regarding direct taxes in 1869, and between Austria and Hungary regarding the taxation of business enterprises in 1869/1870⁸⁴. In 1872 an agreement was signed between the United Kingdom and the Swiss Canton of Vaud concerning inheritance taxes. In 1899 Prussia and the Austro-Hungarian Empire signed a treaty⁸⁵. Between 1901-1913 several more agreements were signed in Europe⁸⁶.

⁸¹ Supra, p.21.

⁸² Supra., p.31.

⁸³ Pires, op. cit., p.95.

⁸⁴ Vogel, op. cit., p.8.

⁸⁵ The League of Nations Document, E.F.S.40, F.15. The Belgium-France agreement on 12.8.1843 is considered as the first agreement in the field of international taxation. Also, the agreement between United Kingdom and Canton of Vaud (Switzerland) is regarded as the first double taxation agreement in 1872

After the First World War, Germany and the states (Austria, Hungary, Poland, Rumania and Yugoslavia) of the former Austro-Hungarian Empire also began to establish bilateral agreements, and from 1930 France became active in this area. All of these agreements were based on the League of Nations Model of 1928⁸⁷. Between 1922 and 1939, 69 general agreements were signed in countries in Central and Northern Europe, Canada, the Dutch Indies, Southern Rhodesia, the Union of South Africa and the United States⁸⁸.

In 1922, a multilateral convention was signed in Rome between the successor States of the Austro-Hungarian Empire and Italy⁸⁹. However, only Austria and Italy ratified it in 1924 and 1926 respectively. Therefore, it did not become more than a bilateral convention⁹⁰.

Also the Scandinavian countries signed various agreements⁹¹ in the field of both reciprocal assistance for the enforcement of tax claims and the exchange of information.

From 1932 onwards the United States signed agreements with Sweden, Norway, Denmark and Iceland, but they were confined to sea carriage companies. After 1939 the United States established conventions of a general nature with Sweden and France.

ab - Multilateral Treaties

Among the following multilateral treaties only the Nordic Pact is in force. Some examples of multilateral treaties are as follows⁹²:

despite the fact that it concerned inheritance taxes, because, the Belgium-France agreement concerned only tax assistance. The League of Nations considers that the agreement between Prussia and Austria-Hungarian Empire on 21.6.1899 is the first double taxation agreement.

⁸⁶ Between Austria and Liechtenstein in 1901, Austria and Greece in 1902, the Austrian Empire and Saxony, Bavaria and Wuttemberg in 1903, Switzerland and Italy in 1904, Austria and Baden in 1908, Prussia and Luxembourg in 1909, Prussia and the Canton of the City of Basle in 1910 and 1911, Hesse and Luxembourg in 1913, Austria and Hesse and Austria and Bavaria in 1913.

⁸⁷ Picciotto, *op. cit.*, p.26.

⁸⁸ Pires, *op. cit.*, p.96.

⁸⁹ Convention for the purpose of Avoiding Double Taxation between Austria, Hungary, Italy, Poland and the Kingdom of the Serbs, Croats and Slovenes, 6.4.1922, reprinted in the League of Nations Document, C.345, M.102, 1928 II.

⁹⁰ Pires, *op. cit.*, p.96.

⁹¹ Finland-Sweden (1943), Norway-Sweden (1949), Denmark- Sweden (1953), Finland-Norway (1954), Denmark-Finland (1955) and Denmark-Norway (1956).

1- The Convention concluded on 6.4.1922, by Austria, Hungary, Italy, Poland, Rumania and Yugoslavia but ratified only by Austria in 1924 and Italy in 1926.

2- The Brazzaville Convention of 15.10.1957 between four States of former French Equatorial Africa: the Central African Republic, Chad, Congo and Gabon concerning approximation of international tax law of these States.

3- The Convention concluded on 13.12.1966 in Fort Lamy between the Central African Republic, Chad, Congo, the Federal Cameroon Republic and Gabon. This convention is applicable to persons domiciled in any of the contracting States and to taxes on income and inheritances, other than registration fees and stamp duty. The residence and source principle have been adopted.

4- The Common African, Madagascan and Mauritanian Organisation (OCAM) General Agreement Reporting Fiscal Co-operation adopted in Fort Lamy on 29.1.1971 between the Governments of the Cameroon Republic, the Central African Republic, Chad, Congo, Dahomey, Ivory Coast, Malgache, Mauritius Islands, Niger, Ruwanda, Senegal, Togo and Zaire. This convention was intended to avoid double taxation on income and inheritances, other registration fees and stamp duty. The residence and source principles are adopted.

5- The convention of the Andean Group concluded between Bolivia, Colombia, Chile (Venezuela signed the Agreement in 1973 and Chile has withdrawn), Ecuador and Peru on 16.11.1971. The agreement was signed in Bogota in 26.5.1969. the Convention was approved by the Mixed Commission of the LAFTA⁹³ conference during their meeting in Cartagena in May 1969.

On 16.11.1971, the Commission of the Andean Group approved the proposal, known as Decision 40, which contains the texts of two conventions. The first one exists among all the member countries, and concerns income and net wealth taxes; the second

⁹² Pires, op. cit., pp.246-248; On 30.3.1931 a general multilateral tax treaty was concluded exempting automobiles registered in one member state from tax in another if entering temporarily - Sol Picciotto, *International Business Taxation*, Weidenfield and Nicholson, London-1992, p.25; Turkey is approved this treaty on 3.3.1934, Act No.2424.

⁹³ The Latin American Free Trade Association.

one exists between a member country of the Andean Group and a non-member country outside the region, and includes income, capital and net wealth taxes⁹⁴.

For the taxation of transportation profits, the first text of the Decision 40 Multilateral Convention adopts the residence principle despite the general acceptance of the source principle between member countries. However, the second text of the Decision-40 Model Convention returns to the source principle⁹⁵. In practice Andean Group Countries follow the OECD Model in their agreements with countries outside the Andean Group (with the exception of treaties between Bolivia - Argentina and Ecuador - Sweden⁹⁶).

6- The Convention concluded in Cairo on 3.12.1973 between the Hashemite Kingdom of Jordan, the Democratic Republic of Sudan, the Arab Republic of Syria, the Republic of Iraq, the State of Kuwait, the Arab Republic of Egypt and the Yemeni Arab Republic. This convention is applicable to taxes on income and inheritances and donations. The residence and source principle have been applied.

7- The Comecon Convention concluded in Miskolc (Hungary) on 27.5.1977 between Bulgaria, Hungary, the German Democratic Republic, Mongolia, the Socialist Republic of Rumania, the Socialist Republic of Czechoslovakia, the Union of Soviet Socialist Republics and Poland⁹⁷. This convention is applicable to all categories of taxes on income and wealth of individuals residing in any contracting state.

8- The Convention concluded in Ulan-Bator (Mongolia) on 19.5.1978 between Bulgaria, Hungary, the German Democratic Republic, Mongolia, the Socialist Republic of Rumania, the Socialist Republic of Czechoslovakia, the Union of Soviet Socialist Republics and Poland. This convention included taxes on income and property of corporations that have a registered office in any contracting state.

⁹⁴ Adolfo Atchabahian: "The Andean subregion and its approach to avoidance or alleviation of international double taxation", *Bulletin for International Fiscal Documentation*, Vol.23(1974), p.314; Costa Ramon Valdes: "Current status of studies and work on tax treaties-LAFTA and Andean Pact Models", *Bulletin for International Fiscal Documentation*, Vol.32(1978), footnote-191.

⁹⁵ Atchabahian, op. cit., p.329.

⁹⁶ Richard J. Vann: "A Model Tax Treaty for the Asian-Pacific Region? (Part II)", *Bulletin for International Fiscal Documentation*, April-1991, p.152.

⁹⁷ See: Tibor Nagy: "CMEA-Multilateral Agreements for the Avoidance of Double Taxation", *Intertax*, 1980, p.174.

9- The UNESCO⁹⁸ - WIPO⁹⁹ convention on the Avoidance of Double Taxation of Copyright Royalties on 13.12.1979, concluded in Madrid after five years work. Because of the absence of a sufficient number of signatories (only three of the forty-four countries), the treaty did not come into force¹⁰⁰.

10- The Nordic Multilateral Double Taxation Convention on Income and Capital (referred to as the Nordic Pact) concluded in Helsinki on 22.3.1983 between Denmark, Finland, Iceland, Norway and Sweden¹⁰¹. It is based on the OECD Model. The treaty was revised in 1987 and 1989. This convention covers taxes on income and wealth.

Another multilateral convention was concluded among the same countries on 9.11.1972 in Stockholm: the Nordic Convention on Mutual Assistance in Tax Matters¹⁰².

The European Free Trade Association (EFTA) investigated the possibility of a multilateral double tax convention within its members¹⁰³. Although the end of the Study they decided not to recommend a multilateral convention¹⁰⁴.

b- The role of international organizations

International Organisations' studies on the development of model conventions in the field of international double taxation did not begin until after the conclusion of World War I¹⁰⁵.

ba - The Council of Europe

On 26.8.1950, the Consultative Assembly of the Council of Europe was requested to produce a report on double taxation. The Secretary-General was entrusted

⁹⁸ United Nations Educational, Scientific, and Cultural Organization.

⁹⁹ The World Intellectual Property Organisation.

¹⁰⁰ H.M.A.L. Hamaekers: "Multilateral Instruments on the Avoidance of Double Taxation", *Bulletin for International Fiscal Documentation*, March-1986, p.99(Unofficial translation of the text).

¹⁰¹ U.N. Manuel, op. cit., p.31. Before this was signed a convention in 1972 which supplemented by a special agreement in 1973 and amended by an additional agreement in 1976. It provided for reciprocal administrative cooperation among the tax officials of those states. For details see: N. Mattson: "Is the Multilateral Convention a Solution for the Future? - Comments with Reflections on the Nordic Experience", *Intertax*, 1985, p.212; Pires, op. cit., p.248.

¹⁰² Hamaekers, op. cit., p.101.

¹⁰³ The Report by the Working Party: The Feasibility of a Multilateral Double Taxation Convention within EFTA, 12.11.1969, EFTA 64/69.

¹⁰⁴ *Infra.*, p.33.

¹⁰⁵ Goldberg, op. cit., p.851.

with studying this area, keeping the Committee of Ministers and the Consultative Assembly of the Council of Europe informed on developments¹⁰⁶. In 1955, the Council of Ministers decided not to proceed with attempts to establish a multilateral convention¹⁰⁷.

On 27.4.1967, a draft recommendation was proposed to the Advisory Assembly on Multilateral Conventions¹⁰⁸. Following advice in 1971 from the Committee on Legal Questions, there is no information on what happened¹⁰⁹.

bb - The European Economic Community

On 5.4.1960, the Commission of the European Economic Community appointed the Fiscal and Financial Committee. The members of the Committee were independent experts. The Committee was chaired by Professor Neumark. In the Committee's 1962 Report it stated¹¹⁰:

"... The best means for securing uniformity in the rules relative to the problem of double taxation is certainly a multilateral convention to be concluded by the member states of the EEC..."

The EEC Commission began studying double taxation within the area of direct taxes in 1964. They considered that the 1963 OECD Model, in practice, had not been used much, and constituted a surprisingly small achievement. On 1.7.1968, the Draft European Convention on Double Taxation was drawn up by the 5th Working Group on International Fiscal Issues of the 14th Directorate General¹¹¹. After that there is no information concerning what happened¹¹².

¹⁰⁶ The Recommendation, 26.8.1950, Document AS (2) 114.

¹⁰⁷ Resolution (51)66, 2.8.1951.

¹⁰⁸ The Document 2322 of the Consultative Assembly of the Council of Europe, 27.4.1967.

¹⁰⁹ Pires, op. cit., pp.102 and 252.

¹¹⁰ The Report of the Fiscal and Financial Committee (Neumark Report), pp.72-74 and the Reports of the Sub-Groups A, B and C (An Unofficial Translation, prepared by H. Thurston), *The EEC Reports on Tax Harmonization*, International Bureau of Fiscal Documentation, Amsterdam, 1963, pp.72-74; See generally: A. J. Easson, *Tax Law and Policy in the EEC*, Sweet & Maxwell, London- 1980, p.193.

¹¹¹ EEC-8th, 9th, 10th General Report and The Segre Report, 1966, p.312 and EEC-Supplement to the Bulletin, No.8, 1967, p.9.

¹¹² Pires, op. cit., p.253.

In 1992, the elimination of double taxation was mentioned as one of the Community's objectives¹¹³. Also, the Ruding Committee recommended that the European Community should agree a common approach on double taxation agreement policy¹¹⁴.

bc - The European Free Trade Association

After the agreement of the ministers of member states of EFTA concerning the possibility of multilateral conventions in Lisbon on 10.5.1963, the EFTA Council established an *ad hoc* work group on 3.3.1964. This group met twenty-six times between 1964 and 1969 and a group report was issued on 12.12.1969, on the feasibility of a multilateral convention on double taxation within EFTA¹¹⁵.

Although its technical feasibility, there were many difficulties, and the Group could not recommend it¹¹⁶, despite the success of a multinational agreement between many EFTA Countries. However, in 1983, some EFTA countries concluded a multilateral convention in Helsinki, known as the Nordic Pact¹¹⁷.

bd - The International Chamber of Commerce

In 1920¹¹⁸, at its founding congress, the International Chamber of Commerce studied the elimination of double taxation with agreements and at its congress in London in 1921, some principles were adopted in this area¹¹⁹. For instance, at the

¹¹³ The European Parliament, Written Answer to Question No.647/92, Official Journal 93/C40, 9.11.1992.

¹¹⁴ The Report of the Committee of Independent Experts on Company Taxation, European Communities, Luxembourg-1992, p.206.

¹¹⁵ Ibid., pp.254-255.

¹¹⁶ Davies, op. cit., p.37.

¹¹⁷ Supra, p.31.

¹¹⁸ Its prehistory goes back to 1905.

¹¹⁹ The International Chamber of Commerce: First Congress (London, 1921), Report of the Select Committee on Double Taxation, I.C.C. Brochure No: 11; Special Report of the British International

London Conference the source principle was preferred. The International Chamber of Commerce stated in both the Congresses in Brussels¹²⁰ and Stockholm¹²¹ that impersonal tax should be levied by the state of source and personal taxes should be levied by the state of domicile. It arranged a series of congresses which were either completely devoted to this subject or dealt with it in some way¹²².

Later they changed this attitude¹²³ and adopted the residence principle in the Brussels Congress. The principle of domicile is supported in their Biennial Congress in Amsterdam in July 1929¹²⁴:

"An essential element in world economic reconstruction is the removal of all dispensable barriers to the flow of capital and goods between countries. Revenue systems devised with an eye directed only to internal economic processes, without recognition of the influence of taxation upon international movements of capital and commodities, almost invariably cause double taxation and are therefore adverse not only to the general interest of world trade, but also to the interest of the particular countries...The International Chamber of Commerce considers that double taxation can be avoided either by taxation according to residence alone, or by taxation according to origin alone, but it recalls and endorses the views of the Economic Experts of the League of Nations and of the Double Taxation Committee of the

Committee, I.C.C. Brochure No: 12 (1921) and Second Congress (Rome, 1923), Double Taxation, I.C.C. Brochure No: 25 (1923).

¹²⁰ The International Chamber of Commerce: Third Congress (Brussels-1925), Resolutions Passed at Third Congress, I.C.C. Brochure No.40(1925), p.9.

¹²¹ The International Chamber of Commerce: Fourth Congress (Stockholm-1927), Resolutions Passed at the Stockholm Congress, I.C.C. Brochure No.60(1927), p.21.

¹²² They were held in Rome in 1923, Brussels in 1925, Stockholm in 1927, Amsterdam in 1929, Washington in 1931, Vienna in 1933, Paris in 1935, Berlin in 1937, Copenhagen in 1939, Montreux in 1947, Quebec in 1949, Lisbon in 1951, Tokyo in 1955, Naples in 1957, Washington in 1959, Mexico in 1963 and New Delhi in 1965.

¹²³ The Committee on Double Taxation, March-1924, reprinted in International Chamber of Commerce: Third Congress (Brussels-1925), Double Taxation - A Survey of the I.C.C. Since the Rome Congress, I.C.C. Brochure No.34(1925), pp.7-8.

¹²⁴ The International Chamber of Commerce: Fifth Congress (Amsterdam-1929), Resolutions Passed at the Amsterdam Congress, I.C.C. Supplement No.I to World Trade, October-1929, pp.9-10.

International Chamber that, in general, the best method of eliminating double taxation is the adoption of the principle of residence."

be - The International Fiscal Association

The International Fiscal Association's studies in the field of double taxation began in 1939¹²⁵ in the Hague. Taxation of sea and air transport has also been studied in Brussels congress and the residence principle has been supported¹²⁶.

bf - The Latin American Institute for Tax Law

The Latin American Institute for Tax Law's research in the area of double taxation began with the Montevideo meeting in 1956 and continued with meetings in Sao Paulo in 1962, Buenos Aires in 1964, Punto del Este in 1970 and Caracas in 1975¹²⁷.

bg - Other Organisations

Besides those, some other organisations have also studied this issue, such as the Organisation of American States, the Latin America Free Trade Association, the International Finance Institute, the Institute for International Law, the International Bar Association and the Inter-American Federation of the Order of Lawyers¹²⁸.

¹²⁵ The Hague in 1947, Rome in 1948, Monaco in 1950, Zurich in 1951, Brussels in 1952, Cologne in 1954, Vienna in 1957, Knokke in 1958, Madrid in 1959, Basle in 1960, Jerusalem in 1961, Athens in 1962, Hamburg in 1964, Stockholm in 1967, Rotterdam in 1969, Washington in 1971, Lousanne in 1973, Mexico in 1974, London in 1975, Sydney in 1978, Berlin in 1981, Montreal in 1982, Venice in 1983.

¹²⁶ Pires, op. cit., pp.103-104.

¹²⁷ Ibid., pp.104-105.

¹²⁸ Ibid., p.97.

CHAPTER III - INTERPRETATION OF TAX TREATIES

1- Generally

Tax treaties, as treaties in general, are international agreements and they are binding on the contracting states under international law¹²⁹. Although treaties attempt to provide assistance through the provision of definitions of various terms, in many cases important terms are often undefined. For example in most double taxation treaties the term "income from international transportation" is commonly used without any attempt to define the types of activities which constitute transportation¹³⁰. Where this occurs, the terms of such agreements require interpretation. The aim of interpretation is to achieve the closest possible approximation to the genuine shared expectations of the parties¹³¹.

When the meaning of the term is clear, the treaty is simply applied, but, if the terms used by the contracting parties in the treaty are not clear, they will have to be interpreted¹³². However, when we say the terms are not clear two different situations may exist. First, there is a fault with the words themselves such as grammatical error. Second, it is not clear that the factual situation is covered by the related term. In the latter, the word may be open textured or in terms of technological developments it is not clear whether the precise words cover new situation such as the meaning of a ship or aircraft. Even the decision that the text of the treaty is clear in itself and there is no need to interpret the related term, the text is really clear is a process of interpretation¹³³. For

¹²⁹ I. A. Shearer, *Starke's International Law*, Butterworths, Edinburgh-1994, p.399.

¹³⁰ See generally, Klaus Vogel: "Tax Treaty Interpretation under the OECD Model", *World Tax Report*, Vol.XVIII(1993), pp.182-185.

¹³¹ Myres S. McDougal - Harold D. Laswell - James C. Miller, *The Interpretation of Agreements and World Public Order*, Yale University Press, New Haven-1967, p.82.

¹³² Asif H. Qureshi, *The Public International Law of Taxation: Cases and Materials*, Kluwer, London-1994, p.365.

¹³³ Robert Jennings - Arthur Watts, *Oppenheim's International Law*, Longman, London - 1996, p.1267; Francis G. Jacobs, "Varieties of Approach to Treaty Interpretation: With Special Reference to the Draft Convention on the Law of Treaties Before the Vienna Diplomatic Conference", *International and Comparative Law Quarterly*, Vol.18(April-1969), p.341.

this reason it is possible to say that interpretation can be made in any stage for application of treaty.

Although for the satisfactory operation of tax treaties both for states and taxpayers the interpretation of tax treaty is extremely important¹³⁴, in terms of different approaches by various jurists the interpretation is a difficult part of treaty of law. The undefined words used in the tax treaties have technical meanings in different countries and, for this reason, it is difficult to find a universal meaning of the words under complicated tax law systems¹³⁵. It has been mentioned that "...there is no part of the law of treaties which a text-writer approaches with more trepidation than the question of interpretation"¹³⁶.

The difficulty has been expressed in *Bohemian Union Bank v. Administrator of Austrian Property*¹³⁷, by Clauson J. that "...while recognising that my duty consists in construing this Treaty and that the consequences in one sense have nothing to do with it, still in construing a document of so much complication as this and one which bears on the face of it traces of inaccurate drafting, I think *I am bound to give consideration to what I must suppose to have been in the minds of those who formed the treaty*(emphasis added)..."

When interpretation is required, question can be raised as to what kind of rules will be followed? At that point, one of the possible problems occurs when, for example, the country of residence and the country of source have applied separately to their national courts to interpret the term of the treaty under their domestic laws. If two parties define the related term in the same manner there is no problem. However, when different meanings may be given to this treaty term, a dispute between two contracting parties is inevitable.

It is believed that if the country that is levying tax is, for example, the country of source, it would be much better to leave the interpretation to the source country¹³⁸. However, in practice the problem is complex by virtue of countries' demands to

¹³⁴ Qureshi, op. cit., p.135.

¹³⁵ John F. Avery Jones et.al., "Dual Residency of Individuals: the Meaning of the Expressions in the OECD Model Conventions-I", *British Tax Review*, Vol.15(1981), pp.15-16.

¹³⁶ A. D. McNair, *The Law of Treaties*, Clarendon Press, Oxford-1961, p.364.

¹³⁷ 1927, 2 Ch. 175.

¹³⁸ Kees van Raad: " Interpretation and Application of Tax Treaties by Tax Courts", *European Taxation*, January-1996, p.4. (Hereinafter referred as van Raad, European Taxation).

interpret the terms in a way that is compatible with their tendency towards enforcing their own national interests.

When interpreting tax treaties, the contracting states of the treaty are free to apply to the Vienna Convention on the Law of Treaties¹³⁹ or the related articles of the OECD, the United Nations or the United States Models. However, if one or both of the contracting states do not use, for example, the OECD Model Treaty, it may not be appropriate to expect them to use the OECD Model rules regarding interpretation. It is also mentioned that since the OECD Model is a treaty text, it must be interpreted according to the Vienna Convention¹⁴⁰.

Generally, the parties anticipate some difficulties of interpretation of terms used in the treaty and definitions are put into the treaty. In addition, they can make an agreement about the interpretation procedure in the event of disputes and in that case these provisions are applied before general rules of interpretation¹⁴¹.

In the case of difficulties or doubts arising from interpretation of the term, if the competent authority¹⁴² of the participating country cannot reach a satisfactory solution, they should contact the competent authority of the other to reach an agreement about the meaning of the term. This is the "mutual agreement procedure" discussed later¹⁴³.

2- Statute or Contract

One problem is which approach should be taken for the interpretation of tax treaties. On the basis that a treaty is a statute, the rules of statutory interpretation should be applied. In this case domestic law rules will apply for interpretation. On the other hand if a treaty is a contract, it is possible to apply the appropriate international law rules on the interpretation. As Raoul Lenz¹⁴⁴ has said¹⁴⁵:

¹³⁹ 23.5.1969, The United Nations Document A/CONF. 39/27 (1969). It came into force on 27.1.1980; See, Jacobs, op. cit., pp.318-346.

¹⁴⁰ Peter Sundgren: "Interpretation of Tax Treaties- A Case Study", *British Tax Review*, 1990, p.290.

¹⁴¹ Jennings-Watts, op. cit., p.1268.

¹⁴² *Infra.*, p.49.

¹⁴³ *Infra.*, p.50.

¹⁴⁴ The General Reporter in the International Fiscal Association's 1960 Report on the Interpretation of Double Taxation Conventions.

"International agreements for the avoidance of double taxation are bilateral treaties and thus belong to the law of nations in the same way as any other political or economic treaty. If the meaning of a treaty provision is not clear then the problem will be solved in the first place by applying the usual rules governing the interpretation of international public law. However, double taxation agreements have a purpose substantially differing from that of normal political or economic treaties because they are intended to reconcile two national fiscal legislation's and to avoid the simultaneous taxation in both countries.

...The rapporteurs...particularly stress the fact that double taxation agreements are bilateral conventions and thus belong to the law of nations, but when they have been ratified and are put into effect by the contracting States, they also belong to the domestic law of such States. An agreement is thus simultaneously subject to the rules of interpretation applicable to international and domestic public law, the rules of public international law taking precedence in cases of dispute."

It can be argued that, even after the approval of parliament, tax treaties are still contracts between the sovereign states. The enacting of appropriate legislation does not change their character as explained by Goulding J. in *Commissioner of Inland Revenue v. Exxon Corporation*¹⁴⁶.

Harman J. agreed with Goulding J. in *Union Texas Petroleum Corporation v. Critchley*¹⁴⁷, stating, "...a double taxation agreement is an agreement. It is not a taxing statute, although it is an agreement about how taxes should be imposed..."

For this reason tax treaties should firstly be interpreted under international law rules, secondly under commentaries of the Model Treaty and the negotiation procedure of the agreements. Otherwise, if tax treaties are treated as statutes, domestic law rules of interpretation will apply, causing problems where the respective domestic rules differ.

¹⁴⁵ Baker:94, p.21.

¹⁴⁶ (1982), 56 T.C. 253.

¹⁴⁷ 1988 S.T.C. 691.

3- The Vienna Convention on the Law of Treaties

In international law the principles of interpretation are mainly based on Article 31, 32 and 33 of the Vienna Convention on the Law of Treaties. It has an authoritative character, since it declares the customary international law of treaties¹⁴⁸. The text of Article 31 of the Vienna Convention is as follows:

"1- A treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose

2- The context for the purpose of the interpretation of a treaty shall comprise in addition to the text, including its preamble and annexes:

(a) any agreement relating to the treaty which was made between all the parties in connection with the conclusion of the treaty;

(b) any instrument which was made by one or more parties in connection with the conclusion of the treaty and accepted by the other parties as an instrument related to the treaty

3- There shall be taken into account, together with the context:

(a) any subsequent agreement between the parties regarding the interpretation of the treaty or the application of its provisions;

(b) any subsequent practice in the application of the treaty which establishes the agreement of the parties regarding its interpretation;

(c) any relevant rules of international law applicable in the relations between the parties.

4- A special meaning shall be given to a term if it is established that the parties so intended."

As seen the main rule is to follow the ordinary meaning of the relevant article, although if there is a special meaning that the parties intended, this meaning should be given. Within the context of ordinary meaning "principle of contemporaneity" is used by

¹⁴⁸ Thomas Buergenthal - Harold G. Maier, *Public International Law*, West Publishing Co., St. Paul-Minneapolis-1990, p.92.

Fitzmaurice to explain that “the terms of a treaty must be interpreted according to the meaning which they possessed, or which would have been attributed to them, and in the light of current linguistic usage, at the same time when the treaty was originally concluded”¹⁴⁹.

The treaty to be interpreted in good faith, without malice, fraudulent intent or circumvention¹⁵⁰ and treaty should not lead to a result that would be manifestly absurd or unreasonable¹⁵¹. The principle of interpretation in good faith flows from the rule *pacta sunt servanda* in Article 26 of the Vienna Convention¹⁵². Although the principle of good faith is self-evident¹⁵³, it is formulated that a state must have bona fide reasons for what it does, and not act arbitrarily or capriciously¹⁵⁴. The principle of good faith in paragraph 1 of the Article is the good faith of the parties to the treaty¹⁵⁵. However, if the parties seek an interpretation of the text from a third party, he also applies the good faith of the treaty partners¹⁵⁶.

The term “context” in paragraph 1 of the Article 31 is open textured although it is defined in paragraph 2. The preamble and annexes to a treaty are included to explain the term “context”. It has been stated that “...the preamble is the normal place in which to embody, and the natural place in which to look for, an express or explicit general statement of the treaty’s object and purposes. Where these are stated in the preamble, the latter will, to that extent, govern the whole treaty”¹⁵⁷.

¹⁴⁹ G.G. Fitzmaurice, “The Law and Procedure of the International Court of Justice, 1951-54: Treaty Interpretation and Other Treaty Points” (Hereinafter referred as Fitzmaurice:1957), *British Yearbook of International Law*, Vol.33(1957), p.212.

¹⁵⁰ G. Schwarzenberger, *International Law and Order*, Stevens, London-1971, p.34.

¹⁵¹ Ian Sinclair, *The Vienna Convention on the Law of Treaties*, Manchester University Press, Manchester-1984, p.115 (Hereinafter referred as Sinclair:1984).

¹⁵² International Law Commission, I.L.C. Yearbook, 1966, Vol.2, p.221.

¹⁵³ The United Nations Secretariat, *The United Nations Yearbook*, 1979, p.174.

¹⁵⁴ G.G. Fitzmaurice, *The Law and Procedure of the International Court of Justice*, Grotius, Cambridge-1986, Vol.I, p.12.

¹⁵⁵ Sinclair:1984, p.120; For details see, Gillian White, “The Principle of Good Faith” in Vaughan Lowe - Colin Warbrick (Editors), *The United Nations and the Principles of International Law*, Routledge, London-1994, pp.230-255.

¹⁵⁶ Sinclair:1984, p.120.

¹⁵⁷ Fitzmaurice:1957, p.228.

The term "context" can be taken with a narrower or wider meaning. The text and other documents related to the conclusion of the treaty is within the narrower meaning. An addition of the subsequent agreements and practice enlarge this meaning¹⁵⁸. In *A-G v. Prince Ernest Augustus of Hanover*¹⁵⁹, it has been expressed that "...I use "context" in its widest sense, which I have already indicated as including not only other enacting provisions of the same statute but its preamble..."

In *Ealing Borough Council v. Race Relations Board*¹⁶⁰, five methods of approach were identified:

"...(1) examination of the social background, as specifically proved if not within common knowledge, in order to identify the social or juristic defect which is the likely subject of remedy; (2) a conspectus of the entire relevant body of the law for the same purpose; (3) particular regard to the long title of the statute to be interpreted (and, where available, the preamble), in which the general legislative objectives will be stated; (4) scrutiny of the actual words to be interpreted in the light of the established canons of interpretation; (5) examination of the other provisions of the statute in question (or of other statutes in *pari materia*) for the light which they throw on the particular words which are the subject of interpretation."

In this case the Vienna context includes items 3,4,and 5 (without brackets) and items 1,2 and brackets in item 5 are wider context¹⁶¹. In another classification, internal context includes everything within the Act itself and external context includes the other items¹⁶².

Also in paragraph 2 of the Article 31, two other instruments are mentioned. First one is any agreement relating to the treaty and the second one is any instrument in connection with the conclusion of the treaty. However, these two types of documents are not necessarily to be considered as an integral part of the treaty and it depends on

¹⁵⁸ Jones et. al., op. cit., pp.90-91.

¹⁵⁹ (1957) A.C. 436.

¹⁶⁰(1972) A.C. 342.

¹⁶¹ Jones et. al., op. cit., pp.91-92.

¹⁶² Idem.

the intention of the parties in each case¹⁶³. If the agreement and instrument part of the “context” of the treaty they become an element in the general rule of interpretation rather than supplementary materials¹⁶⁴.

It is an open question as to whether the Commentaries constitute “context”. The Commentaries could be “context” in terms of Article 31(2)(b) of the Vienna Convention that any instrument made by the parties in connection with the conclusion of the treaty and accepted by the other parties as an instrument related to the treaty. However, it is difficult for the term “in connection with” to fit Commentaries since they even exist whether or not any particular bilateral treaty is concluded without conclusion of a bilateral treaty¹⁶⁵. The Commentaries exist to help to the contracting parties and are not binding on them¹⁶⁶. Therefore, it could be a supplementary means of interpretation rather than “context”, because it is not within the context of treaty itself and fall within the Article 32 of the Vienna Convention.

Another article related to interpretation in Vienna Convention on the Law of Treaties is Article 32 as follows:

“Recourse may be had to supplementary means of interpretation, including the preparatory work of the treaty and the circumstances of its conclusion, in order to confirm the meaning resulting from the application of Article 31, or to determine the meaning when the interpretation according to Article 31,

- (a) leaves the meaning ambiguous or obscure; or
- (b) leads to a result which is manifestly absurd or unreasonable.”

After the application of Article 31 if the meaning of the term is not clear it is possible to apply Article 32. In this case, some other sources would be researched to confirm the meaning of the term after the application of Article 31¹⁶⁷.

¹⁶³ International Law Commission, I.L.C. Yearbook, 1966, Vol.2, p.221.

¹⁶⁴ Sinclair, op. cit., p.129.

¹⁶⁵ Jones et. al., op. cit., p.92.

¹⁶⁶ Ibid., p.93.

¹⁶⁷ See *Goldman v. Thai Airways International Limited*, (1983) 3 All.E.R. 693.

Although the term "preparatory work"¹⁶⁸ is not officially defined, it is explained that "those extrinsic materials which have a formative effect on the final draft of a treaty, and which assist to this extent in the disclosure of the parties' aims and intentions"¹⁶⁹. As an example, an agreed conference minute of the understanding was held to be relevant and helpful in *Fothergill v. Monarch Lines*¹⁷⁰. In the same case Lord Scharman stated that "...if there be ambiguity or doubt, or if a literal construction appears to conflict with the purpose of the convention, the court must then, in my judgment, have recourse to such aids as are admissible and appear to it to be not only relevant but helpful on the point (or points) under consideration...".

Under liberal interpretation¹⁷¹ the text of the treaty and its preparatory work on the same level to determine the real intentions of the parties, however, under strict interpretation¹⁷² the text is the basic material of interpretation and the preparatory work has a secondary or supplementary means of interpretation¹⁷³. If the text of a convention is clear in itself there is no need to apply to preparatory work¹⁷⁴.

Under Article 33 of the Vienna Convention on the Law of Treaties, unless otherwise stated, the text is equally authoritative in each language¹⁷⁵. Also, the terms used in the treaty should have the same meaning in both languages. If there is a doubt about the meaning of the text, articles 31 and 32 will be applied.

Also, some researches have been made by different institutes on treaty interpretations. For example, in 1991, the American Law Institute issued recommendations on suitable aids to income tax treaty interpretation and compared the

¹⁶⁸ or *travaux préparatoires*.

¹⁶⁹ D. P. O'Connell, *International Law for Students*, Steven & Sons, London-1971, p.262.

¹⁷⁰ (1981) A.C. 251.

¹⁷¹ *Infra*, p.53.

¹⁷² *Idem*.

¹⁷³ Louis Henkin - Richard Crawford Pugh - Oscar Schachter - Hans Smit, *International Law-Cases and Materials*, West Publishing Co., St.Paul-Minnessota-1993, p.476; See, D.J. Harris, *Cases and Materials on International Law*, Sweet & Maxwell, London-1991, pp.774-776.

¹⁷⁴ International Court of Justice, Advisory Opinion 1947-1948, I.C.J. 63.

¹⁷⁵ For details see, Dinah Shelton, "Reconcilable Differences? The Interpretation of Multilingual Treaties", *Hastings International & Comparative Law Review*, Vol.20 (1997), pp.611-638.

United States system with the Vienna Convention. The results are summarised as follows:

“1- Consistent with Article 31 of the Vienna Convention and United States judicial precedents, a treaty's express language, giving the terms thereof their ordinary meanings, will apply unless to do so would be clearly at odds with the parties' mutual expectations.

2- Material relevant to treaty interpretation should be given weight based on when it was prepared, whether it was published, and whether preparation was unilateral or bilateral. Pre-ratification materials published by both negotiating countries should be conclusive; great weight should be given to post-ratification agreements published by the competent authorities or administrative agreements and bilateral practices; and little or no weight should be given to unpublished material (unless no other materials exist), the views of individual negotiators, or unilateral post-ratification material published in connection with pending or threatened disputes.

3- In addition to materials that are generally deemed relevant under the principles of the Vienna Convention, practicality dictates that certain items not directly tied to the negotiation of a particular treaty nevertheless be referred to in interpreting that treaty. Those items include the OECD Model (together with its commentary), the United States Treasury Department's technical explanation of the treaty at issue, and any court decisions that can be found which interpret similar treaty provisions.

4- The study recommends restricting use of unpublished materials to cases in which no published items are available, or to cases in which those that are available are not responsive to the question at hand.”¹⁷⁶

¹⁷⁶ Richard E. Andersen: "ALI Study Recommends Changes in U.S. Tax Treaty Policy", *The Journal of International Taxation*, November/December 1991, p.254.

4- The OECD Model

a- Article 3(2)

The OECD Model and its Commentaries are not binding on the OECD Member States, because the Model is not an actual treaty and they are used for guidance¹⁷⁷. Article 3 of the OECD Model is devoted to "General Definitions". Paragraph 2 of the Article 3 states that:

"As regards the application of the Convention by a Contracting State, any term not defined therein shall, unless otherwise required, have the meaning which it has under the law of that State concerning the taxes to which the Convention applies."

Although this paragraph was used for the first time in the 1963 OECD Model¹⁷⁸, it was used in United States-United Kingdom Income Tax and Estate Tax Treaties of 1945 without the term "unless the context otherwise requires"¹⁷⁹.

An important question is when internal law rules may be used for the interpretation? The OECD Model Article 3(2), refer to the internal law to find the meaning of undefined terms¹⁸⁰. For example, Article 10(3) of the OECD Model made reference to the tax law of the distributing company's residence state to find the meaning of dividends. Under the existence different meaning in tax law, the appropriate one should be used, including the general law meaning¹⁸¹.

The idea of reference to internal law as a last resort is supported by some authors and German Supreme Court that "...it is necessary to interpret the article in the first instance on the basis of the context of the treaty itself, and in the second instance on the basis of the principles of German domestic law. It has to be taken into account

¹⁷⁷ Van Raad, European Taxation, p.4; Hugh J. Ault, "The Role of the OECD Commentaries in the Interpretation of Tax Treaties", *Intertax*, 1994/4, pp.144-148.

¹⁷⁸ John F. Avery Jones et.al., "The Interpretation of Tax Treaties with Particular Reference to Article 3(2) of the OECD Model", *British Tax Review*, 1984, p.18, footnote-14.

¹⁷⁹ Idem.

¹⁸⁰ See, *Associates Corporation of North America v. The Queen*, 1980 D.T.C. 6049.

¹⁸¹ Jones et.al., p.22.

what the contracting parties' intentions were..."¹⁸². However, this approach is rejected by some authors on the authority Article 3(2) of the OECD Model, which directs the use of internal law unless otherwise required¹⁸³.

In another example, it is possible to apply to internal law for the term "territory". When countries have offshore oil, their tax jurisdiction could be extended to tax exploration and exploitation activities in their continental shelf area¹⁸⁴. For example, in the United Kingdom, they are taxed as if they were carried on in the territory¹⁸⁵. The references to the territory in the United Kingdom in Acts of Parliament are ambulatory¹⁸⁶, because, to extend its territory is within the prerogative power of the Crown¹⁸⁷.

The use of the OECD Model tax convention as an aid for interpretation is recognised in *Hinkley v. M.N.R.*¹⁸⁸ by the Tax Court of Canada. In *Qing Gang K. Li v. The Queen*¹⁸⁹, the Federal Court of Appeal in Canada made reference to the decisions of Courts in the OECD States to decide the meaning of the words in similar situation in double taxation agreements.

b- The OECD Commentaries

The OECD Commentaries¹⁹⁰ may be referred to as a guide for interpretation in many countries¹⁹¹ including the United Kingdom¹⁹². For example, the OECD

¹⁸² Ibid., pp.105-106.

¹⁸³ Ibid., pp.107-108.

¹⁸⁴ Ibid., p.29.

¹⁸⁵ FA-1973, s.38.

¹⁸⁶ *Infra.*, p.59.

¹⁸⁷ Jones et.al., pp.30-31. See *Post Office v. Estuary Radio* (1967), 1 W.L.R. 1401.

¹⁸⁸ 91 D.T.C. 1336 in Jacques Sasseville: "Interpretation of Double Taxation Conventions in Canada: An Update", *Bulletin for International Fiscal Documentation*, August/September 1994, pp.374-376.

¹⁸⁹ Ibid., pp.376-377.

¹⁹⁰ *Supra.*, p.46.

¹⁹¹ Australia, Belgium, Denmark, Germany, Japan, the Netherlands, New Zealand, Sweden, Switzerland and the United States.

¹⁹² See *Sun Life Assurance Company of Canada v. Pearson*, 1984 S.T.C. 461, 1986 S.T.C. 335; *Fothergill v. Monarch Airlines*, 1981 A.C. 251.

Commentary on Article 8¹⁹³ reviews the necessity of providing interpretation in the following terms:

"The principle that the taxing right should be left to one contracting state alone makes it unnecessary to devise detailed rules, e.g. for defining the profits covered, this being rather a question of applying general principles of interpretation."

The Commentaries are essential sources for courts seeking a common interpretation¹⁹⁴. The Committee on Fiscal Affairs referred to the 1963 Draft Model and the Commentaries stated that " ...the existence of the Commentaries has facilitated the interpretation and enforcement of bilateral conventions along common lines."

In the 1992 OECD Model Convention, the effect of the Commentaries have been stated to be as follows¹⁹⁵:

"As the commentaries have been drafted and agreed by the experts appointed to the Committee of Fiscal Affairs by the Governments of Member countries, they are of special importance in the development of international fiscal law. Although the Commentaries are not designed to be annexed in any manner to the conventions to be signed by Member countries, which alone constitute legally binding international instruments, they can nevertheless be of great assistance in the application and interpretation of the conventions and, in particular, in the settlement of any disputes."

Also, the Council of OECD regarded the Commentary as an aid to the interpretation of the Model¹⁹⁶ when concluding new bilateral conventions or revising existing bilateral conventions.

When the changes made to the Commentaries the question can arise as to which version of commentaries apply to a particular agreement. For example when a double taxation agreement was signed in 1989, the problem should the Commentary of 1977 or

¹⁹³ Para.6.

¹⁹⁴ Vogel, *op. cit.*, p.33; For Canadian cases see, Sasseville, *op. cit.*, pp.374-379.

¹⁹⁵ Introduction, para.29.

¹⁹⁶ Recommendation of the OECD Council, 23.7.1992, C(92) 122/FINAL.

1992 be applied. The 1992 Model mentions that¹⁹⁷, 1977 approach is taken into account after the changes on 1963 Model. In 1977 Model the Committee on Fiscal Affairs said that "...existing conventions should, as far as possible, be interpreted in the spirit of the revised Commentaries, even though the provisions of these conventions did not yet include the more precise wording of the 1977 Model Convention."¹⁹⁸. In other words, the latest Commentary is applied.

c- The Competent Authority

A competent authority¹⁹⁹ is a person who is a resident or national of the Contracting State who has power to resolve problems arising from the interpretation or application of a double taxation agreement under mutual agreement procedure.

When taxpayer of one of the contracting parties has a problem from the application of double taxation agreement, he applies to the court or his own government to solve the problem. If the competent authority find taxpayer's claim serious, tries to find a solution by himself and may advice to change some rules in tax system to his own government. . Otherwise, he refuses the application of the taxpayer.

If the competent authority can not solve the problem by himself, he must speak to the competent authority of the other contracting party. They can reach an agreement to solve the problem or can not find a solution. When there is no solution to the problem of the taxpayer, he can apply to the courts. If there is a solution it applies to the taxpayer's situation immediately.

The OECD Model uses the term "competent authority" within the context of mutual agreement procedure which is placed in Article 25:

"2- The competent authority shall endeavour, if the objection appears to it to be justified and if it is not itself able to arrive at a

¹⁹⁷ Introduction, para.33.

¹⁹⁸ Ibid., para.30.

¹⁹⁹ David Rosenbloom, "Tax Treaty Interpretation", *Bulletin for International Fiscal Documentation*, Vol.34(1980), p.545; For details see Rosenbloom-Langbein, op. cit., p.403; Mary C. Bennett: "Current Tax Treaty Issues", *Bulletin for International Fiscal Documentation*, July/August 1995, pp.342-345.

satisfactory solution, to resolve the case by mutual agreement with the competent authority of the other Contracting State, with a view to the avoidance of taxation which is not in accordance with the Convention. Any agreement reached shall be implemented notwithstanding any time limits in the domestic law of the Contracting States.

3- The competent authorities of the Contracting States shall endeavour to resolve by mutual agreement any difficulties or doubts arising as to the interpretation or application of the Convention. They may also consult together for the elimination of double taxation in cases not provided for in the Convention."

Although mutual agreements are made by the competent authorities under the OECD Model, the Vienna Convention Article 31(3) mention only parties. However, the result is same since the competent authority is representing the related parties²⁰⁰.

The United Nations Model has more detailed explanation than the OECD Model about the mutual agreement procedure in Article 25(4):

"The competent authorities of the Contracting States may communicate with each other directly for the purpose of reaching an agreement in the sense of the preceding paragraphs. The competent authorities, through consultations, shall develop appropriate bilateral procedures, conditions, methods and techniques for the implementation of the mutual agreement procedure provided for in this article. In addition, a competent authority may devise appropriate unilateral procedures, conditions, methods and techniques to facilitate the above-mentioned bilateral actions and the implementation of the mutual agreement procedure."

The United States Model Article 25 also contains a list that differs from the OECD and United Nations Models, when application may be made by the competent authorities to each other:

"...3- The competent authorities of the Contracting States shall endeavour to resolve by mutual agreement any difficulties or doubts

²⁰⁰ Jones et al., op. cit., p.96, footnote-25.

arising as to the interpretation or application of the Convention. In particular the competent authorities of the Contracting States may agree

a- to the same attribution of income, deductions, credits, or allowances of an enterprise of a Contracting State to its permanent establishment situated in the other Contracting State;

b- to the same allocation of income, deductions, credits, or allowances between persons;

c- to the same characterisation of particular items of income, including the same characterisation of income that is assimilated to income from shares by the taxation law of one of the Contracting States and that is treated as a different class of income in the other state;

d- to the same characterisation of persons;

e- to the same application of source rules with respect to particular items of income;

f- to a common meaning of a term;

g- to advance pricing arrangements; and

h- to the application of the provisions of domestic law regarding penalties, fines, and interest in a manner consistent with the purposes of the Convention.

4- The competent authorities also may agree to increases in any specific amounts referred to in the Convention to reflect economic or monetary developments.

They may also consult together for the elimination of double taxation in cases not provided for in the Convention."

The "competent authority" is not always the same person in every case. For example, under the Canada-United States tax convention²⁰¹, the Canadian competent authority is the Minister of National Revenue or his authorised representative that are listed²⁰² in the following order: Deputy Minister, Assistant Deputy Minister (Taxation

²⁰¹ 26.1.1984, Articles III(1)(g)(i) and III(g)(ii).

²⁰² John A. Calderwood: "The Competent Authority Function: A Perspective from Revenue Canada" in the *Report of Proceedings of the Forty-First Tax Conference-1989*, Canadian Tax Foundation, Toronto-1990, p.39:4.



Programs Branch), Director General (Audit Programs Branch), Director (International Audits Division), Chief (Competent Authority Cases Section).

In the United States the competent authority is the Secretary of the Treasury or his delegates who are²⁰³, in order, Commissioner of the Internal Revenue Service, Senior Deputy Commissioner, Deputy Commissioner (Operations), Assistant Commissioner (International), Director (Office of International Programs), Chief (Tax Treaty Division).

Under Turkey-United Kingdom double taxation agreement²⁰⁴, the competent authority of Turkey is the Minister of Finance and Customs or his authorised representative, and the competent authority of the United Kingdom is the Commissioners of Inland Revenue or their authorised representative.

When a competent authority faced with the problem of interpretation of treaties it considers all different aspects of the problem. It examines the policies of its country in that specific area to solve the problem. Contact with other parties' competent authorities may be helpful for an effective and quick solution. Therefore, it seems a useful system to solve the problems arising from the application of double taxation treaties.

5- The methods of interpretation

There are three main schools of thought on treaty interpretations in international law²⁰⁵:

- 1- Intentions of the parties, or founding fathers school,
- 2- The textual, or ordinary meaning of the words, school,
- 3- The teleological, or aims and objects school.

"The teleological or aims and objects school" is the method usually applied to general multinational, in particular social or humanitarian treaties rather than tax treaties

²⁰³ Idem.

²⁰⁴ 19.2.1986, SI: 1988/932, Article 3(1)(l).

²⁰⁵ G.G.Fitzmaurice, "The Law and Procedure in the International Court of Justice: Treaty Interpretation and Certain Other Treaty Points", *British Year Book of International Law*, Vol.28(1951), p.1; Edward Slavko Yambrusic, *Treaty Interpretation-Theory and Reality*, University Press of America, London-1987, pp9-14; Ian Brownlie, *Principles of Public International Law*, Clarendon Press, Oxford-1995, pp.627-632.

which try to establish original intentions of the parties²⁰⁶. A liberal approach is preferred by the "intention of the parties school" for the interpretation of tax treaties. "The textual school" is the more conservative view and important point is the natural and plain meaning of the terms²⁰⁷. It is based on the Vattel's famous statement that "The first general rule of interpretation is that it is not permissible to interpret what has no need of interpretation..."²⁰⁸. In practice, these latter two schools are referred as liberal and strict interpretations, respectively.

The object of the "intention of parties" approach is to ascertain and give effect to the intentions of the parties²⁰⁹. However, for the "aims and objects" school the important point is the general purpose of the treaty itself²¹⁰. Although it is possible to say that these two school have similar approaches for treaty interpretation, there are some differences. For example, the "intentions of parties" school try to find the intention of parties in concluding this treaty.

The teleological school seems a combination of the intention of the parties school and the textual school, since the objects and purposes of the treaty are expressed in the text and preamble and it also tries to find the original aims of the parties in concluding the treaty referring to the negotiations and the circumstances of its conclusion²¹¹. However, it is also expressed that the teleological interpretation is a separate category, because, first the objects and purposes of a treaty can be found to exist at the time of interpretation, not at the time of its conclusion and second it is independent of the original intentions of the parties²¹².

²⁰⁶ David A. Ward: "Principles to be Applied on Interpreting Tax Treaties", *Bulletin for International Fiscal Documentation*, Vol.34(1980), pp.546-547.

²⁰⁷ Martin Dixon, *International Law*, Blackstone Press Limited, London-1996, p.63.

²⁰⁸ Emmerich de Vattel, *The Law of Nations or the Principles of Natural Law*, Vol.III, Bk.II, Ch.XVII, 1758, p.199 (Translated by Charles G. Fenwick in *The Classics of International Law*, The Carnegie Institution of Washington, Washington, D.C.-1916).

²⁰⁹ Fitzmaurice, op. cit., p.1.

²¹⁰ Ibid., p.2.

²¹¹ Jacobs, op. cit., p.319.

²¹² Ibid., p.320.

Also, the teleological school is criticised that the interpreters may fall into the position of a judge or arbitrator²¹³ since the school tries to find the object and purpose of the treaty.

In order to establish the intention of the parties the court may consider other evidence which may be available outside the treaty²¹⁴ such as the documents that contain information about treaty negotiations between two parties²¹⁵. For example, in *Fothergill v. Monarch Airlines Ltd.*²¹⁶ it has been stated that:

"...courts charged with the duty of interpreting legislation in all the major countries of the world have recourse in greater or lesser degree to 'travaux préparatoires' or 'legislative history' (as it is called in the United States)²¹⁷ in order to resolve ambiguities or obscurities in the enacting words...an English Court should have regard to any material which the delegates themselves had thought would be available to clear up any possible ambiguities or obscurities."

In the same case Lord Diplock stated that " The language of an International Convention...should be interpreted unconstrained by technical rules of English legal precedent, but on broad principles of general acceptance."

In some cases such as *IRC v. Commerzbank AG*²¹⁸ some principles are listed for international tax treaties:

- "1- One should to look first for a clear meaning of the words,
- 2- It should be interpreted unconstrained by English law,
- 3- Interpretation should be made in good faith under Article 31 of the Vienna Convention,
- 4- Supplementary means of interpretation under Vienna Convention Article 32 may be used,

²¹³ Malcolm N. Shaw, *International Law*, Grotius Publications Limited, Cambridge-1991, p.584.

²¹⁴ D.P. O'Connell, *International Law*, Stevens, London-1970, p.252.

²¹⁵ *Supra.*, p.41.

²¹⁶ 1980, 3 W.L.R. 209.

²¹⁷ or *preparatory work*, The Vienna Convention on the Law of Treaties, Article 32, *Supra*, p.69; See, Qureshi, *op. cit.*, p.136; D.W. Greig, *International Law*, Butterworths, London-1976, pp.480-481.

²¹⁸ (1990) S.T.C. 285.

- 5- Commentaries to treaties and decisions of foreign courts may be used,
- 6- Discretionary use of 'travaux preparatoires', international case law and the writings of jurists."

A review of cases, starting as early as 1798 in *The Santa Cruz*²¹⁹, reveal that British courts generally tend to favour a liberal interpretation²²⁰ as stated by Lord Stowell that "...for such a treaty of alliance is not a thing *stricti iuris*, but ought to be interpreted with liberal explanations...".

It has been expressed in *Maltass v. Maltass* in 1844 by Dr. Lushington that²²¹ "...we cannot expect to find the same nicety of strict definition as in modern documents, such as deeds, or Acts of Parliament; it has never been the habit of those engaged in diplomacy to use legal accuracy, but rather to adopt more liberal terms..."

In the following years, the liberal interpretation is also supported in various cases²²².

Lord Denning, in *Bulmer Ltd. v. Bollinger S.A.*²²³, clearly relied on the important point, "the purpose and intent" of the treaty which seems a mixture of the liberal and teleological interpretation. He expressed his view that:

"The draftsmen of our statutes have striven to express themselves with utmost exactness. They have tried to foresee all possible circumstances that may arise and to provide for them. They have sacrificed style and simplicity. They have foregone brevity. They have become long and involved. In consequence, the judges have followed suit. They interpret a statute as applying only to the circumstances covered by the very words... How different is this treaty!

²¹⁹ (1798) 1 C. Rob. 50 in Ward, op. cit., pp.546-547.

²²⁰ I.M. Sinclair: "The Principles of Treaty Interpretation and Their Application by the English Courts", *International and Comparative Law Quarterly*, Vol.12(1968), p.550.

²²¹ (1844) 1 Robertson's Ecclesiastical Reports, pp.73 and 76 in idem.

²²² By Lord Herschell C.J. in *Imperial Japanese Government v. P. & O. Steam Navigation Co. Ltd.* (1895 A.C. 644), by Lord Russell C.J. in *Re Arton*(No.2) ((1896), 1 Q.B. 509), by Lord Macmillan in *Stag Line Ltd. v. Foscolo, Mango & Co.* (1932 A.C. 350), by Lord Wilberforce in *Buchanan & Co. v. Babco Ltd.* (1978 A.C. 153) and by Goulding J. in *Commissioner of Inland Revenue v. Exxon Corporation*.

²²³ 1974, 1 Ch. 425.

... Seeing the differences, what are English Courts to do when they are faced with a problem of interpretation. They must follow the European pattern. No longer must they examine the words in meticulous detail. No longer must they argue about the precise grammatical sense. They must look to the purpose and intent."

However, on occasion the strict interpretation is also used by the courts in the United Kingdom. For example, in *Avery Jones v. I.R.C.*²²⁴, Walton J. said that, to find the meaning of the words the document must be checked word by word and "...as far as it is humanly possible, a document must be construed so as to give effect to every word used by the parties and, in deciding what the meaning of those words is, one must look at the document as a whole to see whether those words occur elsewhere, as, if possible, the same construction should be placed on them in both context..."

Other examples of the strict interpretation are *Nothman v. Cooper*²²⁵, *Oppenheimer v. Cattermole*²²⁶ and *I.R.C. v. Commercial Bank*; *I.R.C. v. Banco do Brasil SA*²²⁷.

Turning to Canada, it is stated in the Interpretation Act of Canada²²⁸ that, "...Every enactment shall be deemed remedial and shall be given such fair, large and liberal construction and interpretation as best insures the attainment of its object."

The Canadian Courts have also opted for the liberal interpretation. For example, the liberal interpretation has been supported by RWS Fordham in *Saunders v. M.N.R.*²²⁹:

"...Where a tax convention is involved ... a liberal interpretation is usual, in the interests of the comity of nations. Tax conventions are negotiated primarily to remedy a subject's tax position by the avoidance of double taxation rather than to make it burdensome. This fact is indicated in the preamble to the Convention. Accordingly, it is undesirable to look beyond the four corners of the Convention and Protocol in seeking to ascertain of a particular phrase or word therein."

²²⁴ 1976 S.T.C. 290.

²²⁵ (1975) 1 All ER 538.

²²⁶ (1974), 50 T.C. 159.

²²⁷ 1990 S.T.C. 285.

²²⁸ Section 11.

²²⁹ 54 D.T.C. 524.

Other examples of the liberal interpretation in Canada are *Canadian Pacific Ltd. v. The Queen*²³⁰, *J.N. Gladden Estate v. The Queen*²³¹, *Appleby v. M.N.R.*²³², *Tara Exploration and Company Limited v. M.N.R.*²³³, *Consolidated Premium Ores Limited v. M.N.R.*²³⁴ and *Union Texas Petroleum Corporation v. Critchley*²³⁵.

However, in *Stickel v. The Queen*²³⁶, the strict interpretation has been supported by the Court:

"The consensus of all writers is that treaties are to be construed in the most liberal spirit provided, however, that the sense is not wrested from its plain and obvious meaning....In my view, the duty of the Court is to construe a treaty as it would construe any other instrument public or private, that is, to ascertain the true intent and meaning of the contracting States collected from the nature of the subject matter and from the words employed by them in their context..."

Also, in *British Columbia Railway Co. v. The Queen*²³⁷ and *Sydney S. Fetcher v. M.N.R.*²³⁸, the strict interpretation is supported by the Federal Court.

The United States Courts have also supported the liberal interpretation of treaties²³⁹. As early as in 1880, it is expressed in *Hauenstein v. Lynham*²⁴⁰, that "Where a treaty admits two constructions, one restrictive as to the rights that may be claimed under it, and the other liberal, the latter is to be preferred..."

²³⁰ 76 D.T.C. 6120.

²³¹ 85 D.T.C. 5188.

²³² 79 D.T.C. 172.

²³³ 72 D.T.C. 6288.

²³⁴ 59 D.T.C. 1112.

²³⁵ 1988 S.T.C. 691.

²³⁶ 72 D.T.C. 6178.

²³⁷ 79 D.T.C. 5020.

²³⁸ 77 D.T.C. 185.

²³⁹ Nathan Boidman: "Interpretation of Tax Treaties in Canada", *Bulletin for International Fiscal Documentation*, 1980, p.391, footnote-29.

²⁴⁰ (1880), 100 U.S. 483.

Ten years later, the Supreme Court of the United States followed the same line of thought in favor of liberal interpretation in *Geofroy v. Riggs*²⁴¹. After it has been mentioned that "...it is a general principle of construction with respect to treaties that they should be construed so as to carry out the apparent intention of the parties to secure equality and reciprocity between them...", the same expression in *Hauenstein v. Lynham* is repeated.

Another example of the liberal interpretation is *Factor v. Laubenheimer*²⁴². In this case the expression about to secure equality and reciprocity from *Geofroy v. Riggs* is repeated after stating, "...in choosing between conflicting interpretations of a treaty obligation, a narrow and restricted construction is to be avoided as not consonant with the principles deemed controlling in the interpretation of international agreements..."

In *Maximov v. United States*²⁴³, the Supreme Court rejected the strict interpretation and mentioned the necessity to examine not only language but the entire context of the agreement. Also, in the Suez case²⁴⁴, the intent and purpose of the Convention is examined.

The liberal, strict or teleological terms of interpretation exist not only for international treaties but also for national legislation. For example, in *Bon-Secours v. Communaute Urbaine de Quebec*, Gonthier J. listed five rules for interpretation²⁴⁵:

1- The interpretation of tax legislation should follow the ordinary rules of interpretation;

2- A legislative provision should be given a strict or liberal interpretation depending on the purpose underlying it, and that purpose must be identified in light of the context of the statute, its objective and the legislative intent: this is the teleological approach;

²⁴¹ (1890), 133 U.S. 642.

²⁴² (1933), 290 U.S. 276.

²⁴³ (1963), 375 U.S. 49.

²⁴⁴ 492 F.2d 798 in Boidman, op. cit., p.390.

²⁴⁵ 95 D.T.C. 5017 in J.E. Fulcher: "The Income Tax Act, The Rules Of Interpretation and Tax Avoidance. Purpose vs. Plain Meaning: Which, When and Why?", *The Canadian Bar Review*, Vol.74(1995), pp.565-566.

3- The teleological approach will favour the taxpayer or the tax department depending solely on the legislative provision in question, and not on the existence of predetermined presumptions;

4- Substance should be given precedence over form to the extent that this is consistent with the wording and objective of the statute;

5- Only a reasonable doubt, not resolved by the ordinary rules of interpretation, will be settled by recourse to the residential presumption in favour of the taxpayer.

In my opinion the liberal interpretation is more appropriate than the strict interpretation. The main idea is more important than details and difficulties of expression should not rule out the effectiveness of the agreements. Otherwise, the elaboration of treaties must express all the possible small details in order to cover the countries' aims.

6- Static or Ambulatory interpretation

Another problem area is whether interpretation should be static or ambulatory. In other words, should reference be made to the state's internal law at the time the treaty was concluded or at the time the treaty is applied?²⁴⁶

Belgium, Germany, the Netherlands, Norway and the United States adopt an ambulatory interpretation but Sweden adopts a static interpretation²⁴⁷. The Supreme Court of Canada made its decision in favour of static interpretation in *The Queen v. Melford Developments Inc.*²⁴⁸, but reversed this afterwards by legislation²⁴⁹. Under section 3 of the Income Tax Conventions Interpretation Act of Canada, if the word is fully defined in

²⁴⁶ International Fiscal Association: "Interpretation of Tax Treaties", *Bulletin for International Fiscal Documentation*, Vol.40(1986), pp.76-85.

²⁴⁷ Baker:94, p.38.

²⁴⁸ (1981), Court of Appeals, 81 D.T.C. 5020 and Supreme Court, 82 D.T.C. 6281.

²⁴⁹ The Income Tax Conventions Interpretation Act, 20.12.1984, Canadian Gazette, Part III, 863.

the tax treaty, section 3 is not applicable. Otherwise, the meaning of the word must be consistent with the ambulatory meaning in the Income Tax Act.

Section 3 provides as follows:

"Notwithstanding the provisions of a convention or the Act giving it the force of law in Canada, it is hereby declared that the law of Canada is that, to the extent that a term in the convention is

- a- not defined in the convention,
- b- not fully defined in the convention, or
- c- to be defined by reference to the laws of Canada,

that term has, except to the extent that the context otherwise requires, the meaning it has for the purposes of the Income Tax Act, as amended from time to time, and not the meaning it had for the purposes of the Income Tax Act on the date the convention was entered into or given the force of law in Canada if, after that date, its meaning for the purpose of the Income Tax Act has changed."

In Turkey, an ambulatory interpretation has been adopted since the OECD Model is in use.

In the United Kingdom the situation of the static or ambulatory interpretation is not clear since no application has been made to the Courts. Baker argues that an ambulatory interpretation is preferred by Parliament, since a transitional relief was provided for existing treaties from the changed definition of the term "distributions" under Section 32 of the Finance Act 1966²⁵⁰.

²⁵⁰Baker:94, p.39.

In the 1992 OECD Model the ambulatory interpretation has been adopted²⁵¹. This is also the case in the 1995 amendments of the OECD Model²⁵².

The OECD Article 3(2) Commentary paragraph 11 states that:

"...the question arises as to which legislation must be referred to in order to determine the meaning of terms not defined in the Convention, the choice being between the legislation in force when the Convention was signed or, on the contrary, that in force when the Convention is being applied, i.e., when the tax imposed. the Committee on Fiscal Affairs concluded that the latter interpretation should prevail."

The OECD Article 3(2) Commentary paragraph 12 states that:

"...ambulatory interpretation of internal law is not required if the change in domestic legislation is so significant as to no longer correspond to 'the intention of the contradicting parties when signing the Convention'".

The people who support static interpretation states that changing internal law by the state would prevent the effectiveness of the treaty²⁵³. However, for the people who support the ambulatory interpretation points the difficulty of static interpretation that it takes time to find the related article which is difficult for treaties signed long time ago²⁵⁴.

²⁵¹ The OECD Commentary on article 3, para.11; For details see: Kees van Raad: "1992 Additions to Articles 3(2) (Interpretation) and 24 (Non-Discrimination) of the 1992 OECD Model and Commentary", *Intertax*, 1992/12, pp.673-674.

²⁵² Jonathan Schwartz: "OECD Updates Model Income Tax Convention", *Financial Times World Tax Report*, Vol.XX(1995), p.202.

²⁵³ Vogel, op. cit., p.34.

²⁵⁴ Jones et al., op. cit., p.41.

CONCLUSION

Countries use certain models, the OECD and the United Nations Model, when signing international double taxation agreements. The developed countries prefer the OECD Model, because of its use of the residence principle. In treaties with developed countries the developing countries prefer the United Nations Model which permits use of the source principle in international transportation, because they are capital importing countries and also need tax revenues²⁵⁵.

Although the United Nations Model answers the need of developing countries in relation to the source principle, in practice, the residence principle is used in most of the double taxation treaties between developing countries. This is because developing countries themselves wish to maximise their revenues when dealing with less developed countries.

Although there has been an enormous effort by international organisations and study groups to solve the problem of double taxation, the most common solution is a bilateral agreement between two countries. However, this type of solution could be ineffective in terms of the political and economic inequalities between the negotiating partners.

When countries sign a double taxation agreement, some terms may still remain unclear or ill-defined. In this case the interpretation of the treaty is essential. In order to arrive at the true meaning of the terms, certain interpretation methods can be used by courts. In most cases, liberal interpretation is preferred over strict interpretation which not only looks at the meaning of the words in the text, but also analyses the purpose and intention of the parties who drew up and signed the treaty.

Although the need of interpretation of unclear words gives a difficult time to treaty interpreters, the existence of some guidelines, such as the Vienna Convention, and different methods eases their task. To follow some principles as guidelines will be helpful to solve disputes about treaty interpretation for both parties and international jurists. The interpretation process is also shortened by the mutual agreement procedure.

²⁵⁵ See, Charles R. Irish: "International Double Taxation Agreements and Income Taxation at Source", *The International and Comparative Law Quarterly*, Vol.23(1974), p.292.

There is a limit to how far these different schools of interpretation will give use to different results in practice. When the courts interpret an article of the treaty, they must look at first to the words which are used by the parties. When there are not clear they can try to find the meaning of the term from supplementary material. However, when they are, at the same time, try to establish the intentions of the parties and the purposes of the treaty, they consider the meaning of the term in question under the light of these intentions and purposes. At this point in the three methods of interpretation became very close to each other.

PART II: INTERNATIONAL DOUBLE TAXATION TREATY MODELS WITH SPECIAL REFERENCE TO INTERNATIONAL TRANSPORTATION

CHAPTER IV: TAXATION OF INTERNATIONAL TRANSPORTATION INCOME UNDER THE OECD AND THE UNITED NATIONS MODEL

1- Introduction

Transportation, especially international transportation, is a wide concept which is particularly difficult to define, therefore, several tax are inevitable. Vessels or aircraft need many facilities such as repair, fuelling, stevedoring, embarkation, disembarkation etc.. Furthermore, the passengers require services such as catering, hotels and entertainment.

Although some profits clearly fall within the definition of income from the operation of ships and aircraft, profits from ancillary activities during the operation of a ship or aircraft in international traffic remain problematic. If the ancillary activities fall within the concept of transportation the income from these activities will be taxed as transportation income and subject to the special rules applicable thereto rather than income from trade.

Since most international air transport or shipping²⁵⁶ takes place in international air space or on the high seas, the possible locations of the source of income include:

- the embarkation or disembarkation points of freight
- the place where the tickets are sold
- the place where the business is carried on
- the place where the agency is operating.

²⁵⁶ See, "the meaning of international transportation", *infra.*, p.92.

Also, practical difficulties arise in relation to tax jurisdiction concerning the apportionment of income and expenses²⁵⁷. Sometimes a journey of a ship or aircraft will be between two points in different countries in which case the allocation of the income between two different jurisdictions is relatively straightforward.

If there are several ports or airports, or if cargo is transferred from one ship to another at sea, the problem becomes more complex because the existence of different points in different tax jurisdictions cause difficulties for the allocation of income. To use an allocation method which is acceptable by the countries related to taxation of profits from international transport is problematic. Brennan, J. expressed in *Japan Line v. Country of Los Angeles*²⁵⁸ that:

“Allocating income among various tax jurisdictions bears some resemblance...to slicing a shadow. In the absence of a central coordinating authority, absolute consistency, even among tax authorities whose basic approach is quite similar, may just be too much to ask.”

When some passengers purchase their tickets in different countries or complete part of their journey on a different airline or with different types of transportation further problems arise.

2- Historical Background

a - The League of Nations

In November-1920, Sir Basil P. Blackett was requested to report on double taxation in the British Empire by the Financial Department of the Provisional Economic and Financial Committee of the Council of the League of Nations²⁵⁹.

²⁵⁷ David R. Davies, *Principles of International Double Taxation Relief*, Sweet&Maxwell, London-1985, p.138; Vogel, op. cit., p.387; Dick Hund: "The Development of Double Taxation Conventions with Particular Reference to Taxation of International Air Transport", *Bulletin for International Fiscal Documentation*, Vol.36(1982), p.113.

²⁵⁸ (1979) 441 U.S. 434.

²⁵⁹ Pires, op. cit., p.97.

In 1921, the League of Nations decided to examine the question of international double taxation and appointed four independent economists, Professors Bruins, Einaudi, Seligman and Sir Josiah Stamp, to undertake a study of the subject. Two years later they published their report²⁶⁰.

In 1922, the League of Nations appointed a committee of technical experts drawn from the tax authorities of seven European countries²⁶¹ to study the practical aspects of double taxation and fiscal evasion. After the Technical Committee issued their first report in 1925²⁶² its membership was enlarged first by the addition of Germany, Japan, Poland, Venezuela and Argentina in 1926 and the United States in 1927. It concerned itself with the avoidance of double taxation and mutual administrative assistance, and published four draft conventions²⁶³.

In 1928, the League of Nations published a summary of the observations by the various governments²⁶⁴.

The General Meeting of Government Experts on Double Taxation and Tax Evasion was held in October 1928 in Geneva²⁶⁵, and was attended by Government experts from 27 countries. They adopted a Draft Model for Bilateral Convention for the

²⁶⁰ The Report on Double Taxation, League of Nations Document, E.F.S.73, F.19 (1923); reprinted in League of Nations Publications, II Economic and Financial, No.28, 1923.

²⁶¹ Belgium, Czechoslovakia, France, Italy, the Netherlands, Switzerland, the United Kingdom.

²⁶² The Report and Resolutions Submitted by the Technical Experts on Double Taxation and Tax Evasion to the Financial Committee of the League of Nations, League of Nations Document, C.115, M.55, 1925 II (F.212).

²⁶³ The Report Presented by the General Meeting of Government Experts on Double Taxation and Tax Evasion, the Draft of a Bilateral Convention for the Prevention of Double Taxation, League of Nations Documents, C.216, M.85, 1927 II; C.562, M.178, 1928 II; C.613, M.190, 1928 II A; W. H. Coates: "Double Taxation and Tax Evasion", *Journal of the Royal Statistical Society*, Vol.92(1929), pp.585- 593.

²⁶⁴ Summary of the Observations Received by August 30th, 1928 from the Governments on the Report submitted by Committee of Technical Experts on Double Taxation and Tax Evasion, League of Nations Document, C.495, M.147, 1928 II.

²⁶⁵ The Report Presented by the General Meeting of Government Experts on Double Taxation and Tax Evasion, Bilateral Convention for the Prevention of Double Taxation in the Special Matter of Direct Taxes, League of Nations Document, C.562, M.178, 1928 II; For details see: Ke Chin Wang: "International Double Taxation of Income: Relief Through International Agreement 1921-1945", *Harvard Law Review*, Vol.59 (1945), pp.77-78; Coates, op. cit., p.587; Davies, op. cit., p.34.

Prevention of Double Taxation in the Special Matter of Direct Taxes which also contains two further alternatives to this Draft²⁶⁶, together with three other Draft Model Bilateral Conventions about duties, administrative assistance in matters of taxation and judicial assistance in the collection of taxes²⁶⁷.

The taxing power was given to the source country²⁶⁸. However, "...that power was limited in practice by the pattern of international flows of private capital in the era preceding the Great Depression. In fact, most foreign investment in capital receiving countries at the time took the form of portfolio investment, the income from which was taxable under the convention...in the country of the investor's fiscal domicile which the convention...defined as the normal residence of the taxpayer. There was relatively little direct investment, which in the light of the newly formulated concept of 'permanent establishment' would have been liable to a large degree to taxation in the source country."

In 1929, the League of Nations appointed a permanent Fiscal Committee on the suggestion of the General Meeting of Government Experts²⁶⁹ for studying the field of international double taxation. The Report²⁷⁰ of the Fiscal Committee of the League of Nations addressed the possibilities of multilateral conventions²⁷¹. Part of the Report was adopted as a draft convention in 1931 to replace the 1928 Model.

A Sub-committee meeting was held in New York and Washington with the support of the International Chamber of Commerce²⁷². The draft allocation convention was published first as a draft multilateral convention in June 1933²⁷³ and then re-issued as

²⁶⁶ The Report Presented by the General Meeting of Government Experts on Double Taxation and Tax Evasion, League of Nations Document, C.562, M.178, 1928II, pp.7,16 and 19.

²⁶⁷ The United Nations Manual, p.17; Wang, op. cit., pp.90-92; Picciotto, op. cit., pp.22-24.

²⁶⁸ 1935 Report of the Fiscal Committee, p.5(Annex).

²⁶⁹ The United Nations, First Report.

²⁷⁰ The League of Nations, "Report of the Fiscal Committee to the Council on the Work of the Third Session of the Committee", League of Nations Document, C.415, M.171, 1931 II A.

²⁷¹ It is also called Plurilateral Convention.

²⁷² The United Nations Manual, p.18.

²⁷³ The League of Nations, Fiscal Committee, "Report of the Fourth Session of the Committee, Draft Convention Adopted for the Allocation Business Income Between States for the Purposes of Taxation", League of Nations Document, C.399, M.204, 1933 II A. (F./Fiscal. 76).

a draft bilateral convention in June-1935²⁷⁴, but was never adopted. The Fiscal Committee stated that²⁷⁵:

"The existence of model draft treaties has proved of real use ... in helping to solve many of the technical difficulties which arise in [the negotiation of] tax treaties. This procedure has the dual merit that, on the one hand, in so far as the model constitutes the basis of bilateral agreements, it creates automatically a uniformity of practice and legislation, while, on the other hand, in as much as it may be modified in any bilateral agreement reached, it is sufficiently elastic to be adopted to the different conditions obtaining in different countries or pairs of countries."

Also the Committee stated regarding to the adoption of model conventions that they could lead "to more satisfactory results and have a wider and more lasting effect than the convocation of an international conference with a view to concluding a multilateral convention, even though it may at first attract less general attention and interest."²⁷⁶

The Draft Convention of 1933 adopts the principle of residence mitigated by the existence of a permanent establishment, unlike the 1928 Draft Conventions of 1931 which used the source principle. The 1933 Draft Convention stated in article I that:

"An enterprise having its fiscal domicile [its real centre of management] in one of the contracting States shall not be taxable in another contracting State except in respect of income directly derived from sources within its territory and, as such, allocatable, in accordance with the articles of this Convention, to a permanent establishment [real centres of management, branches, mines and oil wells, plantations, factories, workshops, warehouses, offices, agencies, installations, and other fiscal places of business, but not including a subsidiary company] situated in such State..."

²⁷⁴ The League of Nations, "Report of the Fiscal Committee to the Council on the work of the fifth session of the Committee", League of Nations Document, C.252, M.124, 1935 II A., p.4, para II(B)(4).

²⁷⁵ Idem.

²⁷⁶ Idem.

During the last meeting of the Committee before the Second World War a revision of the early Models was suggested in order to take account of new developments in the field of international trade and of the technical improvement in the bilateral tax treaties during the 1930's. This work was started by a subcommittee that met in the Hague in 1940 and continued in the two regional tax conferences in Mexico, in April 1940 and July 1943, which were attended by representatives from Latin America, Canada and United States²⁷⁷. The second conference adopted a Draft Model Bilateral Convention for the Prevention of the Double Taxation of Income (the Mexico Model) which replaced the three earlier draft conventions and the 1935 Allocation of Business Income Convention²⁷⁸. Article II of the Protocol to the Mexico Model²⁷⁹ stated that:

"...2- Should a taxpayer possess a residence in both the contracting States, the competent administration shall determine, by common agreement, the place of his main residence, which shall be considered as his fiscal domicile. In order to determine, as between several residences, the main residence, the competent administration will take into account elements such as duration, regularity, frequency of stays, the place where the family of the taxpayer is usually present, the proximity to the place where the party concerned carries out his occupation.

3- In the case of a taxpayer having a residence in both of the contracting States of which either can be considered as his main residence, Article-XVII shall apply.

²⁷⁷ Argentina, Bolivia, Canada, Chile, Colombia, Ecuador, Mexico, Peru, the United States, Uruguay and Venezuela.

²⁷⁸ The League of Nations Fiscal Committee: Model Bilateral Conventions for the Prevention of International Double Taxation and Fiscal Evasion, Second Regional Tax Conference, Mexico, D.F., July 1945, League of Nations Document, C.2, M.2, 1945 II A.

²⁷⁹ Mexico Model Bilateral Convention for the Prevention of International Double Taxation of Income, Article-II(4), at p.17.

4- The fiscal domicile of partnerships, companies and other legal entities or de facto bodies shall be the State under the laws of which they were constituted."

Article XVII of the Convention states that, "...the competent authorities of the two contracting states may confer together and take the measures required in accordance with the spirit of the Convention."

In other words, after the adoption of source principle in the 1928 Draft Bilateral Conventions and 1931 Draft Conventions, the Mexico Model adopted the residence principle like 1933 Draft Convention.

Also a new development in the Mexico Model was the definition of the term "fiscal domicile" that had earlier caused confusion because of the different meanings it had been given such as the centre of control, the place of registration and the longest period of residence²⁸⁰. It is defined as "the State under the laws of which partnerships, corporations and other legal entities have been constituted."²⁸¹.

After the conclusion of World War II, the Fiscal Committee of League of Nations, meeting in London to revise the Mexico Model, drafted the Model Bilateral Convention for the Prevention of the Double Taxation of Income and Property (London Model)²⁸² in March 1946. The general structure of the London Model convention was similar to the Mexico Model, but some changes had been made²⁸³.

²⁸⁰ Wang, *op. cit.*, p.97.

²⁸¹ Protocol to Mexico Model Bilateral Convention for the Prevention of the Double Taxation of Income, Article-II(4), at p.14.

²⁸² London and Mexico Model Tax Convention, League of Nations Document, C.88, M.88, 1946 II A.

²⁸³ *Infra.*, p.87.

Despite the fact that the principles contained in both the Mexico and London Model Conventions were followed in several bilateral agreements, they never gained the wide degree of usage generated by other models particularly as the OECD Model²⁸⁴.

The reason might be that the OECD Model is more comprehensive and fulfils better the needs of the modern world. In addition the double taxation agreements were not as common then as today.

b - The United Nations

In 1946, the Fiscal Committee of League of Nations declared that "...the work done both in Mexico and in London could be usefully reviewed and developed by a balanced group of tax administrators and experts from both capital-importing and capital-exporting countries and from economically advanced and less advanced countries, when the league work on international problems is taken over by the United Nations."²⁸⁵

In 1947, the Fiscal Commission of the United Nations invited the Secretary-General to make a review and revision of the work by the League of Nations in the field of international tax problems. At its second meeting in 1949 the subject was a convention for eliminating double taxation²⁸⁶.

At the third meeting in 1951, the subject was tax on international transport. The Union of Soviet Socialist Republics, Czechoslovakia and Poland were opposed to exemption from double taxation of profits. Also, the International Civil Aviation Organisation prepared a proposal concerning taxation of air transport enterprises by their countries of domicile, but the Commission refused, by a majority, to support this proposal at the main sessions in 1951 and 1953²⁸⁷.

²⁸⁴ The United Nations Manual, p.20.

²⁸⁵ The League of Nations, Fiscal Committee: Report on the work of the tenth Session of the Committee, C.37, M.37, 1946 II.A, p.8.

²⁸⁶ Pires, op. cit., p.98.

²⁸⁷ Picciotto, op. cit., p.51.

A general resolution was approved to support the avoidance of double taxation by bilateral agreements. In 1954, at the 18th meeting of the Economic and Social Council, the activities of the Fiscal Commission were considered unnecessary and brought to a close²⁸⁸.

The cold war hostility and the general differences between developed and developing countries and also between other countries prevented any progress²⁸⁹.

On 4.8.1967, the United Nations requested the Secretary-General to set up an *ad hoc* group of experts²⁹⁰ on tax treaties between developed and developing countries²⁹¹. The main purpose was to draft a Model Convention between these types of countries. The Secretary-General set up the *ad hoc* group of experts in 1968²⁹². This group met eight times from 1969 to 1979²⁹³ and produced eight reports²⁹⁴. In 1974 they issued preliminary

²⁸⁸ Pires, op. cit., p.99.

²⁸⁹ Picciotto, op. cit., p.51.

²⁹⁰ For details see, Surrey, op. cit., pp.1-67.

²⁹¹ The United Nations, Economic and Social Council Resolution 1273 (XLIII); League of Nations Mexico and London Model Conventions, League of Nations Document, C.88, M.88, 1946 II A; 1963 OECD Draft and 1977 Model Double Taxation Conventions; The United Nations Model Double Taxation Convention Between Developed and Developing Countries, 1980. See also: International Fiscal Association Congress Seminar Series, No.4, Deventer-1979; UN Draft Model Taxation Conventions.

²⁹² Tax officials and experts from the following countries: Argentina, Chile, France, Germany, Gana, India, Israel, Japan, the Netherlands, Norway, Pakistan, the Philippines, the Sudan, Switzerland, Tunisia, Turkey, the United Kingdom and the United States. Also Sri Lanka in 1972 and Brazil in 1973 joined the group of experts.

²⁹³ Under the observation of Austria, Finland, Mexico, Nigeria, the Republic of Korea, Swaziland, Venezuela and following international organizations: the International Monetary Fund, the International Fiscal Association, the Organization for Economic Co-operation and Development, the Organization of American States, the International Chamber of Commerce, the United Nations Centre on Transnational Corporations and the United Nations Conference on Trade and Development.

²⁹⁴ First Report, U.N. Doc. E/4614, ST/ESA/110 (1969). Second Report, U.N. Doc. E/4936, ST/ESA/137 (1970). Third Report, U.N. Doc. ST/ESA/166 (1972). Fourth Report, U.N. Doc. ST/ESA/188 (1973). Fifth Report, U.N. Doc. ST/ESA/18 (1975). Sixth Report, U.N. Doc. ST/ESA/42 (1976). Seventh Report, U.N. Doc. ST/ESA/79 (1978). Eighth Report, U.N. Doc. ST/ESA/101 (1980)(Yellow Book).

guidelines for negotiations²⁹⁵ that were superseded in 1979 by the production of a manual containing a new set of guidelines²⁹⁶.

Finally, the Model for the United Nations Double Taxation Convention between developed and developing countries was drafted²⁹⁷ and approved on 22.4.1980 by the United Nations Economic and Social Council²⁹⁸. Today, it is commonly in use between countries as the United Nations Model.

The United Nation Model is not in general sufficient to meet developing countries' needs because it is based on the residence principle rather than source principle²⁹⁹. It does not help developing countries' efforts to attract foreign capital and technology, nor does it include the matching credit method and the tax sparing method for the prevention of double taxation³⁰⁰.

On the matter of the source principle the United Nations Guidelines state, in relation to shipping and other income, that³⁰¹:

"In considering taxes on business profits and income from immovable property, the primary right of the source country to impose tax has not been in dispute. However, the pattern of agreements between developed countries has not made the same use of this principle with respect to income from movable property (namely, interest, dividends and royalties) and income from shipping.

²⁹⁵ The United Nations Department of Economic and Social Affairs, The Guideliness for Tax Treaties Between Developed and Developing Countries, United Nations Document, ST/ESA/14 (1974).

²⁹⁶ The United Nations Manual, op. cit., pp.1-161; Rosenbloom - Langbein, op. cit., pp.368-369; For some current United States treaty issues see, Carl Estes, "Tax Treaties", *International Lawyer*, Vol.14(1980), pp.508-515; for aspects of conventions see: Pires, op. cit., pp.257-258.

²⁹⁷ The Draft United Nations Model Double Taxation Convention Between Developed and Developing Countries, United Nations Document, ST/SG/AC.8/L.29 (1979).

²⁹⁸ Tax Treaties Between Developed and Developing Countries, United Nations Document, E/1980/C.1/L.3/Rev.1/(1980).

²⁹⁹ See, the differences between the United Nations and the OECD Model regarding international transportation, *infra.*, pp.?

³⁰⁰ Dornelles, op. cit., p.384.

³⁰¹ The United Nations Department of Economic & Social Affairs, The Guidelines for Tax Treaties Between Developed and Developing Countries, United Nations Document, ST/ESA/14 (1974).

The main thrust of the consensus reached in the formulation of guidelines and technique by the Group of experts has been to state explicitly this principle of primacy -but not exclusivity- for a country to impose a tax at the source. This approach reflects a modification of a prevailing Model Convention prepared by OECD³⁰² for use among developed countries, which, in the area of investment income and shipping, relies more strongly on reduced taxation at source or sometimes exclusive taxation by the country of residence.

At the same time, as a correlative to the right to taxation at source, the Group has emphasised that source-country taxation of income from international capital would: (a) take into account expenses allocable to the earning of the income so that such income would be taxed on a net basis; (b) not be so high as to discourage investment; and (c) take into account the appropriateness of a sharing of revenue with the country providing the capital. These considerations are especially important with respect to withholding taxes levied on the outflow of dividends, interest, royalties and so on, and to taxes on shipping profits..."

The source principle was offered as a primary right whereby tax could be imposed on shipping incomes, but the tax should not be set at too high because this could discourage investment by foreign companies. There should also be an element of appropriateness in the shaping of revenue between source and investor country. This is where developed countries have reservations about the source principle; the use of the source principle, instead of the residence principle, could effect their national interest.

c - The Organisation for Economic Co-operation and Development

In July of 1958, the Fiscal Committee of the OEEC³⁰³ began to draw up a new model double taxation convention³⁰⁴. Between 1958 and 1961 four reports were prepared

³⁰² *Infra.*, p.76.

³⁰³ The Organization for European Economic Co-operation which was set up in 1956, later expanded to become the Organization for Economic Co-operation and Development on the accession of Canada and the United States on 30.9.1961. In 1971 the OECD Fiscal Committee was renamed the Committee on Fiscal Affairs.

by the committee³⁰⁵. The fifth and final report presented in 1963³⁰⁶, was recommended by the Council and was published as the 1963 Model Double Taxation Convention of the OECD³⁰⁷.

The 1963 OECD Model was developed from the London Model³⁰⁸ and adopted the same basic principles and structure³⁰⁹. The OECD Fiscal Committee was originally charged to prepare a multilateral convention but, because of the difficulties associated with multilateral models discussed earlier³¹⁰, it concentrated on drafting a bilateral Model convention.

In 1965, the Fiscal Committee of the OECD expressed³¹¹ that "...the essential fact remains that tax conventions which capital exporting countries have found to be of value to improve trade and investment among themselves and which might contribute in like ways to closer economic relations between developing and capital-exporting countries are not making sufficient contributions to that end...Existing treaties between industrialised countries sometimes require the country of residence to give up revenue. More often, however, it is the country of source which gives up revenue. Such a pattern may not be equally appropriate in treaties between developing and industrialised countries because income flows are largely from developing to industrialised countries and the revenue sacrifice would be one-sided. But there are many provisions in existing tax conventions that have a valid place in conventions between capital-exporting and developing countries too."

³⁰⁴ The Fiscal Committee of the OEEC, First Report, The Elimination of Double Taxation, 1958, pp.16-17.

³⁰⁵ First Report(1958), Second Report(1959), Third Report(1960) and Fourth Report(1961).

³⁰⁶ The Fiscal Committee of the OECD, Fifth Report, The Elimination of Double Taxation, 1963, pp.35-58.

³⁰⁷ The Model Convention of the OECD for the Avoidance of Double Taxation with Respect to Taxes on Income and Capital, OECD Document No: C.(63) 87, 1963 (Blue Book).

³⁰⁸ Supra, p.70.

³⁰⁹ Davies, op. cit., p.36; Philip Baker, *Double Taxation Agreements and International Tax Law*, Sweet & Maxwell, London-1991, p.1.(Hereinafter referred to as Baker: 1991)

³¹⁰ Supra., p.25.

³¹¹ The OECD, Fiscal Incentives for Private Investment in Developing Countries: Report of the Fiscal Committee, Paris-1965, paragraphs 163 and 165, OECD Publication No.2365011.

The OECD Fiscal Committee began studying revisions of the 1963 OECD Model from 1967 onwards, at the same time as the United Nations group. In 1974, the OECD published proposed amendments to the 1963 Model³¹², and in April 1977³¹³ the OECD issued a Model Double Taxation Convention with revised articles and commentaries, based on the experiences of OECD member states since 1963³¹⁴.

The OECD also issued a Model Convention on Estates and Inheritances in 1966³¹⁵. A revised version, which included gifts, was published in 1982³¹⁶.

The OECD 1963 and 1977 Models were the main models used between developed and developing countries, until preparation of the UN Model Double Taxation Convention Between Developed and Developing Countries was completed in 1980. Since 1980, both the OECD and the United Nations Models have been used³¹⁷.

Both the 1963 Model and the 1977 Model have commentaries attached that were prepared by the OECD Fiscal Committee. They are helpful for the interpretation of the Model³¹⁸ and are formally referred to by the Council of the OECD³¹⁹. The Commentaries have been referred to as an aid to interpretation in the United Kingdom³²⁰, the United States³²¹, Switzerland, Federal Germany and Belgium³²². Members of the OECD may register observations on the commentaries.

³¹² The OECD, Double Taxation of Income and Capital, Paris, 1974.

³¹³ The Revised Model Convention of the Organization for Economic Co-operation and Development for the Avoidance of Double Taxation with Respect to Taxes on Income and Capital, OECD Publication No: 22 77 011.

³¹⁴ The Report of the OECD Committee on Fiscal Affairs, Model Double Taxation Convention on Income and on Capital, Paris, 1977.

³¹⁵ The OECD, Draft Convention for the Avoidance of Double Taxation on Estates and Inheritances, Paris, 1966.

³¹⁶ The Report of the OECD Committee on Fiscal Affairs, Model Double Taxation Convention on Estates and Inheritances and Gifts, Paris, 1982.

³¹⁷ The Report of the OECD Committee on Fiscal Affairs, *supra* footnote 144, p.8.

³¹⁸ The Report of the OECD Committee on Fiscal Affairs, p.6.

³¹⁹ The Recommendation of the Council, 11.4.1977.

³²⁰ *Sun Life Assurance Company of Canada v. Pearson* (1984), S.T.C. 511, 1986 S.T.C. 347.

³²¹ *U.S. v. A.L. Burbank & Co. Ltd.*, 525 F.2 d 9 (2 d Cir. , 1975).

³²² John F. Avery Jones and Others: "Dual Residence of Individuals: the Meaning of the Expressions in the OECD Model Conventions-I", *British Tax Review*, Vol.15(1981), p.20.

In 1986, the Business and Industry Advisory Committee of the OECD put forward some suggestions for a revision of the model and Working Party No.1 of the Committee on Fiscal Affairs has been charged with the task of preparing a revised model³²³.

In 1991 The Committee decided that the revision of the convention and commentaries should be a continuing process, and it would periodically update and amend the documents without waiting for a complete revision³²⁴. A loose-leaf structure was adopted, which provides³²⁵:

- 1- Immediate publication of a revised version of the Model.
- 2- Recognition of the revision of the Model Tax Convention is now a continuous process.
- 3- Easier revision in light of views of the member countries.

On 23.7.1992 a new OECD Model Treaty was published³²⁶, bringing two amendments and several minor revisions to the 1977 Model. Also in following years, further amendments have been made.

Because of the developments in international business and relations the OECD Model Treaty needs to change continuously. For this reason, after the publication of 1992 OECD Model Treaty several working groups are required to eliminate difficulties in the international tax area. Otherwise every possible problem has to be solved each time by treaty partners with bilateral tax negotiations.

In practice after a slow start, the OECD Model Treaty has achieved a great deal. Despite the fact that countries could not find a solution for multilateral agreements they commonly use the OECD Model Treaty for their bilateral agreements and negotiations.

³²³ Baker: 1991, p.4; for details see : Dick Hund: "Towards a Revised OECD Model Tax Treaty?", *Intertax*, 1989/6, pp.212-213.

³²⁴ David G. Broadhurst: "Revisions to the OECD Model, Convention", *Canadian Tax Journal*, Vol.40(1992), p.1347.

³²⁵ Jacques Sasseville: "The OECD Model Tax Convention Is Revised", *The Journal of International Taxation*, March-1993, p.130.

³²⁶ The Report of the OECD Committee on Fiscal Affairs, Model Tax Convention on Income and on Capital, Paris, 1992.

However, the OECD Model Treaty generally gives advantages to developed countries, and developing countries prefer the United Nations Model treaty³²⁷. Even some developed countries have their own Model Tax Treaty, such as the United States, but these tend to follow the OECD Model.

3- The Taxation Principles of International Transportation Companies' Profits

Three main direct taxation principles can be found in double taxation agreements³²⁸:

- the residence principle
- the source principle
- the nationality principle

Under the residence principle a state has a right to tax its residents' income wherever arises. For example, if country X uses the residence principle and a company has a residence in country X and an income in country Y, country X has a right to tax this company's income.

Under the source principle, a state has a right to tax an income which is earned from sources within its geographical territory. For example, if a foreign company has an income in country B, country B has a right to tax this company's income although that company has a residence in a foreign country.

Under the nationality principle a state has a right to tax its citizens' income, wherever arising. For example, if a person is a citizen of country Z, but has an income in another country, country Z has a right to tax this income.

In practice, some countries, such as Argentina and Venezuela, tax solely on the basis of the source principle while other countries, such as the United States and the Philippines, use the residence, source and the nationality principles in combination³²⁹.

³²⁷ Richard J. Vann: "A Model Tax Treaty for the Asian-Pacific Region", Part-I, *Bulletin for International Fiscal Documentation*, March-1991, p.102.

³²⁸ *Supra.*, p.10.

³²⁹ The United Nations Department of International Economic and Social Affairs, *The Manual for the Negotiation of Bilateral Tax Treaties Between Developed and Developing Countries*, United Nations

Beside these principles, the place of effective management principle is also in use in some double taxation agreements. These principles are also in use for the taxation of international transportation income in double taxation agreements.

When some of the principles above coincide there are some disadvantages. For example, if company X has a residence in country A and is doing business between country B and C, it will be subject to tax in country X because of its residence. If country B and C use the source principle company X will also be subject to tax in country B or C. In this case double taxation appears, since company X subject to tax in two countries.

To take an example from the trade of international transportation, if company X used the ports of country B and C only for couple of hours still it would be subject to tax since country B and C use the source principle, there may well be a finding of source. If company X is engaged in tramp shipping between various countries its income may also be subject to tax in country A, since it has a residence there. The same problem may also arise when the nationality principle and the source principle combine. The adoption of one common principle rather than have two conflicting ones prevents double taxation.

In Article 8³³⁰ of the OECD Model Convention the place of effective management principle has been used for the taxation of profits from the operation of ships or aircraft and from inland waterways transport. The place of effective management within the meaning of Article 8 of the OECD Model for international transportation, is the location of the top level of management of an enterprise engaged in international transportation³³¹.

Some countries prefer to use a combination of the residence and place of effective management principles³³². This situation is expressed in the Commentaries that the countries who wants to follow this principle can use the following lines³³³:

Documents, ST/ESA/94 (1979), pp.11-12; See Lindstone, op. cit., p.921; Robert J. Patrick Jr.: "A Comparison of the United States and OECD Model Income Tax Conventions", *Law & Policy in International Business*, Vol.10(1978), p.614.

³³⁰ *Infra.*, p.88.

³³¹ The OECD Model, Article-4.

³³² The OECD Commentary on Article 8, paragraphs 2 and 3.

"Profits of an enterprise of a Contracting State from the operation of ships or aircraft, other than those from transport by ships or aircraft, operated solely between places in the other Contracting State, shall be taxable only in the first-mentioned State. However, where the place of effective management of the enterprise is situated in the other State and that other State imposes tax on the whole of the profits of the enterprise from the operation of ships or aircraft, other than those from transport by ships or aircraft operated solely between places in the first-mentioned State, may be taxed in that other State."

If the place of effective management and the residence of the international transportation company are in different states, some countries prefer to confer the exclusive taxing rights on the state of residence. In this case they can use the following lines³³⁴:

"Profits of an enterprise of a Contracting State from the operation of ships or aircraft in international traffic shall be taxable only in that State."

An "enterprise of a Contracting State" means, an enterprise carried on by a resident of a contracting state³³⁵.

Apart from the residence, source, nationality and effective management principle the "permanent establishment" principle, that is, a fixed place of business through which the business of an enterprise is wholly or partly carried on³³⁶.

Since international transportation company could have many different permanent establishments in different countries the problem arises as to which one of them can appropriately be subject to tax. For example, an international transportation company may have an office in Country A and Country B, and have an agent in Country C. In this case the company may be subject to tax in Countries A, B and C.

³³³ Ibid., para.3.

³³⁴ Ibid., para.2.

³³⁵ The OECD Model, Article 3(1)(c).

³³⁶ Article 5 of the The OECD, the United Nations and the United States Model Treaties.

In order to cater for the needs of the developing countries, the United Nations Model contains a wider definition of the term "permanent establishment"³³⁷ than the OECD Model.

The OECD Fiscal Committee stated in 1965 that³³⁸:

"...Existing treaties between industrialized countries sometimes require the country of residence to give up revenue. Most often, however, it is the country of source which gives up revenue. Such a pattern may not be equally appropriate in treaties between developing and industrialized countries because income flows are largely from developing to industrialized countries and the revenue sacrifice would be one sided. But there are many provisions in existing tax conventions that have a valid place in conventions between capital exporting and developing countries too."

The permanent establishment principle is inadequate for the solution of the potential multiple taxation of international air and sea transport, because of the difficulties of allocating income and expenses.

Under "reciprocal exemption", the exclusive right to tax is given to one state, usually the state where the enterprise is resident or where its effective management is situated, rather than the state of source.

Without any reciprocal exemption and the existence of different principles in different countries, ships involved in international transportation may be subject to tax in different countries which will lead to international double taxation. In that case the shipping companies will be tempted to register their ships under a flag-of-convenience. The reciprocal exemption which is provided by these countries increases the attractiveness of foreign registry³³⁹.

³³⁷ *Infra.*, p.103.

³³⁸ The OECD, Fiscal Incentives for Private Investment in Developing Countries, The Report for the OECD Fiscal Committee, OECD Publication No. 23 65 011 (1965), pp.57-58.

³³⁹ Marcia Field - Richard Gordon, *Tax Treatment of Income from International Shipping*, Broch International, Amsterdam-1979 (International Bureau of Fiscal Documentation), p.72.

Reciprocal exemption may be given under a bilateral double tax treaty, by national legislation, under the bilateral air services agreements that govern scheduled flights between states³⁴⁰, under an exchange of diplomatic notes, or even under an informal "gentleman's agreement". If a country wants to implement a reciprocal exemption by statute, the enactment of a similar provision in the other country is sufficient without any other requirements³⁴¹.

Two objectives of the reciprocal exemption of shipping profits have been stated in 1930 by the Special Assistant to the Secretary of the Treasury³⁴²:

"...first, the very practical purposes of simplification by attempting to avoid allocation of the income derived. A ship, for example, carries freight from the United States to Great Britain. How much of the freight charge is derived from the United States and how much is attributable to the voyage to Great Britain, and how the expenses should be allocated, are very difficult questions.

Second, ...the fact that the income should be subject to tax but once. The present law is based on the principle that the United States will tax the American ship on all its income wherever derived and the foreign country will tax its ship on all of its income wherever derived."

An example can be given regarding treaty exemption involving two corporations³⁴³: Corporation A is incorporated in the United Kingdom and owned by United Kingdom residents. Corporation B is incorporated in Saudi Arabia and owned by Saudi residents. Corporations A and B have formed a 50/50 partnership with each other in the field of international transportation and the partnership generates United States source gross transportation income. Of the two countries, only the United Kingdom

³⁴⁰ The International Air Transport Association has drawn up a draft model tax clause for inclusion in air services agreements which would give reciprocal tax exemption along the lines of the 1966 International Civil Aviation Organization Resolutions and Recommendation covering taxation of fuel, lubricants and other consumable technical supplies ; taxes on income, property or capital; and taxes on the sale or use of international air transport (Davies, op. cit., p.139).

³⁴¹ Jon E. Bischel - Robert Feinschreiber, *Fundamentals of International Taxation*, Practising Law Institute, New York-1985, p.272.

³⁴² The Revenue Ruling 74-170.

³⁴³ Outtersen-Cheung, op. cit., p.593.

provides an equivalent corporate exemption by treaty. By virtue of the treaty, Corporation A's portion of the United States gross transportation income will be exempt, only Corporation B's portion will be subject to tax.

The principle of reciprocal tax exemption under Article 8 of the OECD and United Nations Models applies even if the operation of ships and aircraft in international traffic is not directly involved with the treaty country. For example, an airline company registered in Country A has a sales office in Country B although it does not operate any routes to or from Country B. Under double taxation agreement between countries A and B, the profits of the company from this sales office will be exempted from tax in Country B.

Some developing countries do not use the principle of reciprocal exemption, particularly in relation to shipping, when it has little or no international shipping of its own. The alternative article³⁴⁴ allowing the state of source to tax international shipping operations in the United Nations Model, does not apply to international airline operations.

The profits of international air, sea or inland transportation corporations derived from international activities will not be automatically exempt from tax in the source country. Source country taxation will apply if the trade is business carried on in the source country through a permanent establishment under the Article 7 (Business Profits). Examples of such activities are a shipyards, hotels, travel agency, package holidays and warehousing³⁴⁵.

Private research has been conducted on the provisions related to only air transportation in bilateral tax treaties between 1956-1980 which covered 307 treaties and found that only 13 of them prefer the source principle³⁴⁶. The research can be summarised as follows:

Between developed countries³⁴⁷, 149 double taxation treaties were signed. In general, 80 of them adopt the state of effective management principle (3 of them with

³⁴⁴ *Infra.*, p.89.

³⁴⁵ Davies, *op cit.*, p.142.

³⁴⁶ Hund, pp.113-114(Annex).

³⁴⁷ Here the 24 member states of the OECD, *supra.*, p.19.

registration) while 69 of them follow the residence principle (18 of them with registration).

Between developed and developing countries 136 double taxation conventions were signed. 34 of them adopt the state of effective management principle (2 of them with registration), 85 of them follow the residence principle (9 of them with registration) and 12 of them use the source principle. 5 of them have no specific provision. The taxation in the source country principle is preferred only by Singapore, Malaysia, Sri Lanka and the Philippines³⁴⁸.

Between developing countries only one of the ten treaties provides for taxation in the source country³⁴⁹. 2 of them follow the place of effective management principle and 7 of them adopt the residence principle.

Interestingly, it seems that even developing countries are prepared to seek an advantage over less-developed countries whenever it is in their interest and they have the necessary diplomatic weight to achieve this.

Also, the research includes a separate category of about 12 treaties between developed countries and former Eastern European Countries. Six of them adopt the place of effective management principle and other 6 treaties follow the residence principle (2 of them with registration).

Developing countries would naturally like to use the source principle more than developed countries³⁵⁰, because they are capital importing countries and also need tax revenues. If developing countries adopt the residence principle they cannot tax foreign companies' income in their own country.

When developing countries make an agreement providing for the use of the source principle, they can increase their tax revenues. Since this is vital for the growth of the developing country, developing countries try to establish the source principle in most double taxation agreements, except where it is to their advantage not to.

³⁴⁸ Hund, op. cit., p.113.

³⁴⁹ For conclusion see *infra*, p.108.

³⁵⁰ See, Irish, op. cit., p.292.

The development of principles concerned specifically with international transport as opposed to international trade in general began in the 1920s. The early period witnessed the undertaking of studies at an international level on the general problems of double taxation and particularly double taxation of international transportation³⁵¹.

Although the permanent establishment principle governed business profits, in this early period, there is no explanation on to why the real centre of management principle was adopted for sea and air transportation. The reason may originate from private companies doing business in the field of international transportation. Because, the permanent establishment principle does not benefit the shipping and air transportation companies if they have a transportation business in a country which has lower tax rates than the country of permanent establishment.

In this case the transportation companies prefer to adopt other principles in the models which is suitable for them. For example, in the Geneva model³⁵², when the transportation companies have a real centre of management in a flag-of-convenience country, such as Liberia or Panama, they would pay less tax than in their country of permanent establishment.

This would be an appropriate reason for the adoption of different principles for shipping and air transportation companies.

The possible solutions for the allocation of income are:

- 1- To find a formula for the allocation of income between countries,
- 2- To make an agreement and give a taxing right to one country.

The first solution is to find a formula to allocate income between related jurisdictions. Although the United States using 50 per cent rule which could be an allocation of income method, the main reason for the adoption of the rule was to increase the revenues from international transportation.

³⁵¹ Supra., p.65.

³⁵² Supra., p.66.

However, it seems quite difficult to find a formula to allocate the income between two jurisdictions. When there is more than two jurisdictions, which is quite likely given the nature of international transportation, the problem becomes worse.

The issue has been expressed in the following lines:

"The fundamental aims in taxing international income flows are three: to allocate tax revenues between jurisdictions in a way recognized by each as fair...; to neither encourage nor discourage international capital flows; and to enable countries, within reason, to impose the domestic tax system of their choice. The present international order does not succeed well at any of these objectives.

It produces what all would accept as fair results only in exceptional circumstances (of equal flows between countries with similar tax systems) [a condition that also presumes relatively equivalent degrees of economic development]; it both discourages and especially encourages capital flows of various sorts, thus biasing the international allocation of capital and making the world a poorer place; and it inevitably undermines the viability of domestic tax systems."³⁵³

When there is no agreement between countries the income from international transportation may become subject to tax in two or more jurisdictions. This is a situation which international transportation companies wish to avoid.

For example, X is an international transportation company resident in country A and carrying on business between country A and country B. If country A uses the residence principle and country B uses the source principle for the taxation of income from international transportation, the profits of company X will be subject to tax in two jurisdictions at the same time³⁵⁴.

³⁵³ By Richard Bird in J. Scott Wilkie and Others: "The Foreign Affiliate System in View and Review" in *Tax Planning for Canada-United States and International Transactions*, Corporate Management Tax Conference-1993, Canadian Tax Foundation, Toronto-1994, p.2:9.

³⁵⁴ For details see, Stanley Surrey: "Reflections on the allocation of income and expenses among national jurisdictions", *Law & Policy in International Business*, Vol.10(1978), pp.409-418.

Under the second solution, where countries apply different tax principles such as source, residence or effective management principles reciprocal exemption agreement between countries gives taxing rights to the other country. In practice, giving up taxing right, which is a sovereign issue, is quite difficult for every country and closely related with the political power of countries. Also, in practice it could be against the developing countries' benefit since they do not have sufficient political power.

The Mexico Model of 1943³⁵⁵ and the 1946 London Model³⁵⁶ have a separate article for shipping and air transport. Article 5 of the 1943 Mexico Model states that:

"Income which an enterprise of one of the Contracting States derives from the operation of ships or aircraft registered in such State is taxable only in that State."

Article 5 of the 1946 London Model states that:

"Income which an enterprise of one of the contracting States derives from the operation of ships or aircraft engaged in international transport is taxable only in the State in which the enterprise has its fiscal domicile."

The first difference between the 1946 London Model and the 1943 Mexico Model is the shift to "*fiscal domicile*"³⁵⁷ from transportation registration of ships or aircraft in the 1946 model. Secondly, in the London Model the term "*international*" has been added: i.e. the income must be derived from international transport.

There is no official explanation for the reason to add the word "international" into the context of the London Model. The Committee who prepared the London Model possibly noticed some potential future problems. For example, the lack of the term "international" would prevent the taxation of international transportation companies. Another possibility for the absence of the term "international" in the Mexico model may be a simple oversight.

³⁵⁵ Supra., p.69.

³⁵⁶ Supra., p.70.

³⁵⁷ Idem.

In 1964, the British Commonwealth produced a Model Commonwealth Taxation Agreement which contains a special provision for taxation of international sea and air transportation under the residence principle³⁵⁸.

In addition to these, in 1971, the Andean Pact³⁵⁹ adopted the residence and the source principles that were later embodied in a model convention published by the successor to the Andean Pact, the Latin American Free Trade Association³⁶⁰. In multilateral treaties, there is an almost universal use of the residence principle³⁶¹.

4- Article 8 of the OECD and the United Nations Model

The OECD and the United Nations Models apply to taxpayers who are resident of one or both of the contracting states³⁶².

In practice, the OECD and the United Nations Models have been very influential in the development of double taxation relief in the field of international transportation. The OECD 1963, 1977 and 1992 Models³⁶³ contain specific articles for shipping, inland waterways transport and air transport. In the three different versions of the OECD Model, paragraphs 1 and 2 of Article 8 state that:

"1- Profits from the operation of ships or aircraft in international traffic shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated.

2- Profits from the operation of boats engaged in inland waterways transport shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated."

Due to disagreement between experts from developed and developing countries on a common solution for shipping and air transport, the United Nations Model contains two alternatives: Article 8 A, also referred to as Alternative A, and Article 8 B, also referred to as Alternative B. Article 8 A is the same as the OECD Model Article 8.

³⁵⁸ Hund, op. cit., p.112.

³⁵⁹ Supra., p.29.

³⁶⁰ Hund, op. cit., p.112.

³⁶¹ Ibid., p.113.

³⁶² Article 1.

³⁶³ Supra., p.77.

Article 8 B includes an extra paragraph (Paragraph 2) which replaces the effective management principle for the source principle in relation to certain shipping activities, but the effective management principle is maintained for air transport³⁶⁴.

Paragraphs 1 and 2 of Article 8 B state that:

"1- Profits from the operation of aircraft in international traffic shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated.

2- Profits from the operation of ships in international traffic shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated unless the shipping activities arising from such operation in the other Contracting State are more than casual. If such activities are more than casual, such profits may be taxed in that other State. The profits to be taxed in that other State shall be determined on the basis of an appropriate allocation of the over-all net profits derived by the enterprise from its shipping operations. The tax computed in accordance with such allocation shall then be reduced by ... per cent. (The percentage is to be established through bilateral negotiations)"

The interesting point to adopt a separate paragraph for international transportation profits in the United Nations Model is limited to shipping. Although the United Nations Model offers the alternative Article 8B as an option for developing countries which do not want to use the residence principle, the article does not cover other types of transportation, especially air transportation. The income from air transportation is subject to tax, like the OECD Model, in the place of effective management which has been adopted in Article 8A.

In terms of economic developments, the developing countries do not have sufficient sources such as airports to exploit air transportation effectively. However, the protection of sea transportation does not make sense for some developing countries which do not have a coastline and have necessarily to use other types of transportation, at least to reach foreign ports for sea transportation.

Although it is helpful to have an alternative article for the needs of developing countries, it is difficult to say that the problems have been fully covered. The alternative Article 8B should include other types of transportation, at least air transportation to match the heading of Article 8.

³⁶⁴ Supra., p.88.

When the shipping activities are not more than casual the profits can be taxed in the state of effective management. However, if the shipping activities are more than casual, the profits from the shipping operations can be taxed in the state of source rather than the state of effective management. This is the case with many developing countries³⁶⁵.

Apart from the term international traffic, considered separately³⁶⁶, several parts of Article 8 B require further interpretation. The phrase "*more than casual*" means a scheduled or planned visit of a ship to a particular country to pick up freight or passengers³⁶⁷.

Shipping activities are deemed to be more than casual if the ship visits the other contracting State according to a fixed schedule, or even if the ships only make planned irregular visits to pick up or unship cargo in the other contracting State. Tramp shipping, that does not make regular trips but takes goods to any port, may be considered no more than casual unless there is an isolated call³⁶⁸.

The problem of allocation of income has been left to the bilateral negotiations between contracting parties without any solution³⁶⁹.

Paragraph 3 of Article 8 of the OECD and the United Nations Models states that:

"If the place of effective management of a shipping enterprise or of an inland waterways transport enterprise is aboard a ship or boat, then it shall be deemed to be situated in the Contracting State in which the home harbour of the ship or boat is situated, or, if there is no such home harbour, in the Contracting State of which the operator of the ship or boat is a resident."

This paragraph is related to a special situation. The place of effective management of the enterprise could be on board a ship or boat. In this situation, the state where the home harbour of the ship or boat is situated has a right to tax the

³⁶⁵ The United Nations Model, Article 8B, para.2.

³⁶⁶ *Infra.*, p.93.

³⁶⁷ Vogel, *op. cit.*, p.394.

³⁶⁸ *Idem.*

³⁶⁹ The United Nations Model, Article 8B, para.2.

income from international transportation. A home harbour is the port from which the shipping business actually operates.

If it is not possible to determine that port, which is highly possible in the case of tramp ships, then the Contracting State where the operator of the ship or boat is resident tax the profits from international transportation.

The rules includes not only ships but also boats engaged in inland waterways transport.

However, if the ship or boat does not have a home harbour and the operator's residence is on board the ship or boat it is not clear how to tax the income from international transportation. In this situation, the state of flag which the ship is flying has a right to tax the income from international transportation and if a ship has no flag, it is illegal³⁷⁰.

Besides paragraphs 1, 2 and 3 of Article 8 of the OECD and UN Models, certain terms are placed in paragraph 4 of Article 8. Paragraph 4 of Article 8 of the OECD and United Nations Models state that:

"4- The provision of paragraph 1 shall also apply to profits from the participation in a pool, a joint business or an international operating agency." (Paragraph 4 was not included in the 1963 OECD Model).

The terms "pool", "joint business" and "international operating agency" are taken from the International Air Service Transit Agreement of 7.12.1944³⁷¹ and are not defined in the Models. The effective management principle also applies to those profits.

The terms include all forms of co-operation such as the pooling of supplies of spare parts at airports, the alternating operation of certain flight routes and the merger of enterprises³⁷².

³⁷⁰ Vogel, p.405.

³⁷¹ *International Legislation* (Ed. Manley O. Hudson-Louis B. Sohn) Vol.IX (1942-1945), Oceana Publications, New York-1972, p.228.

³⁷² Vogel., op. cit., p.405.

5- The Meaning of International Transportation in Double Taxation Models and Treaties

The question is raised as to why international transportation is considered so important a form of international business that it requires separate articles in the OECD, the United Nations and the United States Models?

Taxation of international shipping had been differentiated from taxation of ordinary business in a report by four experts which was produced in 1923³⁷³. The reason for this was the international character and wide scope of international shipping transportation³⁷⁴. However, other international businesses may share these characteristic so it is not appropriate to explain the difference in terms only of its international character. Also, the difficulty for the allocation of income, could be important since there is no explanation for this different treatment of international transportation.

Also the Commentary on the three versions of the Geneva Conference in 1928³⁷⁵ notes that the provisions on sea and air transport form an exception to the principle which normally applies in the case of enterprises, but gives no further information³⁷⁶.

The idea of different treatment for international transportation which was created in 1923 is still in use in the OECD and the United Nations Models. The only difference is the addition of international air transportation in the context of international transportation.

The heading of the Article 8 in the OECD and the United Nations Model include only shipping, inland waterways and air transportation. However, the United States Model which is used in the United States double taxation agreements only covers sea and air transportation but not inland waterways transportation.

³⁷³ *Supra*, p.66.

³⁷⁴ Air transport was not considered at that time.

³⁷⁵ *Supra*, p.66.

³⁷⁶ Hund, *op. cit.*, p.111.

Article 8 of the OECD and the United Nations Models refers to "*shipping, inland waterways transport and air transport*". Both Models use the terms "... *the operation of ships or aircraft in international traffic* ..." and "... *the operation of boats engaged in inland waterways transport* ..." in their texts.

The term "international traffic" is defined in Article 3 (1)(d) of the OECD Models as follows³⁷⁷: "*For the purposes of this Convention unless the context otherwise requires, the term international traffic means any transport by a ship or aircraft operated by an enterprise which has its place of effective management*³⁷⁸ *in a contracting State, except when the ship or aircraft is operated solely between places in the other contracting State.*"

When an enterprise of Contracting State sells tickets for a passage in another state through an agent in the other Contracting State and if tickets are valid between points within the State of effective management or within a third State³⁷⁹ it is international traffic and Article 8 applies for the taxation of profits from the sale of tickets. The other Contracting State only has a right to tax income if the operation solely placed within its own borders.

The use of the term "solely" in Article 3 (1)(d) implies that the entire voyage must begin, end and take place within the state³⁸⁰.

The definition of international traffic does not include the situation where an enterprise situated in one state is responsible for a voyage carried out entirely within the other member state. In this event, either the profits will be taxed under another article, or the countries concerned will have to negotiate a new definition. Another possibility is that the profits will be taxed in the other treaty state³⁸¹.

³⁷⁷ The OECD Committee on Fiscal Affairs, Model Convention on Income and on Capital, Paris-1992, p. M.6. The text is added by the 1977 Model Convention.

³⁷⁸ Supra., p.79.

³⁷⁹ Vogel, op. cit., p.391.

³⁸⁰ Baker: 1991, op. cit., p.141. The territory of a state may be defined so as to include the area over the continental shelf, so that activities within that area are not international traffic (footnote-5).

³⁸¹ Davies, op. cit., p.140.

Another sort of transportation covered by the models is "*inland waterways transport*" which has no definition. However, in the Commentary to Article 8, rivers, canals and lakes are treated as a inland waterways transportation. Paragraph 16 of the Commentary states that:

"The object of this paragraph is to apply the same treatment to transport on rivers, canals and lakes as to shipping and air transport in international traffic. The provision applies not only to inland waterways transport between two or more countries, but also to inland waterways transport carried on by an enterprise of one country between two points in another country."

Despite this explanation in the Commentary that inland waterways transport has the same treatment as international sea and air transportation, in the main text of Article 8 its international character is not mentioned. In many cases inland waterways transport has an international character such as Great Lakes or St. Lawrence River between the United States and Canada.

Another difficulty is to determine the concept of the terms "ship" and "aircraft" since no definitions of the terms have been supplied by the OECD and the United Nations Models. In this situation, to interpret the related term is inevitable.

The term "ships" probably includes all means of transport moving on or under water, including submarines and hydrofoils³⁸². Engines are not necessary, for this reason, floating plastic containers designed for the transportation of liquids are within the scope of Article 8³⁸³. However, some watercraft such as dredge boats, fishing vessels, sea-going tugs, floating docks and floating desalination facilities are not covered by Article 8, because these watercraft were not designed for international traffic. Hovercraft are generally considered to be ships or boats³⁸⁴.

³⁸² Vogel, op. cit., p.389; For details see, D.P. O'Connell, *The International Law of the Sea*, Clarendon Press, Oxford-1984, pp.747-750.

³⁸³ Vogel, op. cit., p.389.

³⁸⁴ Idem.

An interesting point related to Article 8 concerns a technical distinction. In the first paragraph the term "ships" is used for international traffic, but in the second paragraph the term "boats" is used for inland waterways transport. It is difficult to understand why treaty makers think that only boats can operate in inland waterways transport and ships in international sea transportation.

The term "aircraft" covers all flying machines that take off from, or touch down on, water or land and are capable of moving in air space³⁸⁵. Spacecraft such as the Space Shuttle may also be included under the term, if they provide transportation³⁸⁶. Again, hovercraft are excluded from the definition³⁸⁷.

In the Model Treaties other sorts of transportation, such as road transport, rail transport and pipeline transport, are not specifically covered. Article 3(1)(d) as we have seen³⁸⁸, defines international traffic as transportation by ships or aircraft. However, the OECD Commentary on Article 3(1)(d)³⁸⁹ states that:

"...the definition of the term 'international traffic' is broader than the term normally signifies."

This contrast is quite confusing as it is not clear how it fits with the narrow definition of the article itself. Any type of transportation can be within the definition of the term "international traffic" under this explanation of the commentary.

As seen, not only is a separate article adopted for international transportation but it is technically limited to shipping and air transportation although some types of transportation are different than each other as stated in *Pullman's Place Car Co. v. Pennsylvania*³⁹⁰ "...commerce on land between the different States is so strikingly dissimilar, in many respects, from commerce on water, that is often difficult to regard

³⁸⁵ Idem.

³⁸⁶ Idem.

³⁸⁷ Idem.

³⁸⁸ Supra., p.93.

³⁸⁹ The OECD Commentary on Article 3(1)(d), para.6.

³⁹⁰ 1891 in Jerome R. Hellerstein - Walter Hellerstein, *State Taxation-Vol.I-Corporate, Income and Franchise Taxes*, Warren Gorham Lamont, U.S.A. - 1993, pp. 4.50-4.51.

them in the same aspect...", still land transportation could be as international as shipping and air transport.

In spite of the title of Article 8 - shipping, inland waterways transport and air transport -, in practice, treaties often define international traffic to include other forms of transport, such as road and rail transport - land transport.

When an enterprise operates ships or aircraft both in international and internal traffic, Article 8 applies only to the international part of the traffic³⁹¹. The internal transportation operations which take place solely within one state are subject to tax of that state,

When a ship or aircraft undertakes a voyage but does not return, for example, if the craft is being delivered for use in another country, this voyage will not constitute international traffic for the purposes of Article 8³⁹².

Very few agreements include inland waterways transport and in some double taxation agreements the term "international traffic" is not defined.

Quite surprisingly, the Andean Pact Model Convention in 1971 contains most different types of transportation together which is difficult to see in the other Models³⁹³. The alternative Article 8 of the Andean Pact in which the source principle³⁹⁴ is adopted stated that:

"The profits earned by a transportation enterprise from its air, land, sea, lake or river operations in any of the Contracting States, shall be taxable only by such Contracting State."

There is still no double taxation agreement which includes all types of transportation and the Andean Pact is a good example for the OECD and the United

³⁹¹ Vogel, op. cit., p.392.

³⁹² Idem.

³⁹³ Infra., p.64.

³⁹⁴ Hund, op. cit., p.112.

Nations treaty as how their Article 8 could be worded. It has the broadest concept of international transportation.

6- The Profits from International Transportation

One of the important problems in Article 8 is the meaning of the phrase "*profits from the operation of ships or aircraft*". The phrase covers profits from the carriage of passengers or cargo but it also covers other classes of profits which, by reason of their close relationship, may be placed in the same category³⁹⁵.

For the determination of the meaning of the phrase, different activities must be considered. For example, the following activities are within the concept of "profits from the operation of ships or aircraft"³⁹⁶:

- 1- the sale of passage tickets on behalf of other enterprises³⁹⁷;
- 2- the operation of a bus service connecting a town with its airport;
- 3- advertising and commercial propaganda;
- 4- transportation of goods by truck connecting a depot with a port or airport (this is added by the 1974 Revised Text).

Also, paragraph 9 of the Commentary on Article 8 states that:

"...where the goods are delivered directly to the consignee in the other Contracting State, such inland transportation is considered to fall within the scope of the international operation of ships or aircraft and, therefore, is covered by the provisions of this Article."

³⁹⁵ The OECD Commentary, Article 8, para. 4.

³⁹⁶ Ibid., para. 8.

³⁹⁷ In a Rhodesian case, a United Kingdom resident airline booked a sea passage for its passenger, and received a commission. The Special Court held that this income was incidental to operating the aircraft. The Commission was therefore not taxable in the country of source (Rhodesia) under the United Kingdom - Rhodesia double taxation treaty - *Income Tax Case, No: 1048* (1964), 26 S.A.T.C. 226 in Michael Edwardes-Ker (Editor), *International Tax Treaties*, The International Tax Revenue Service, In*Depth Publishing Limited, London-1992, pp.6-7 of Article 8.

The profits from other auxiliary activities, such as maintenance, catering and ground handling carried on by airlines not mentioned in the Commentaries may be covered by Article 8³⁹⁸.

Despite the preceding point, the operation of a lorry depot is generally considered a separate and independent business. It should be within the context of Article 8 if the depot exclusively serves the storage of goods or products in transit and if the storage costs are included in the freight charges³⁹⁹.

A ship-building yard is excluded from Article 8 by the commentary⁴⁰⁰. Also, the investment income of shipping, inland waterways or air transport enterprises⁴⁰¹ does not fall within Article 8⁴⁰².

The catering service run by a hotel or its restaurant; or restaurants, snack bars, shops etc., or the like on board a ship are not considered within Article 8, unless the shipping enterprise operates them itself⁴⁰³. However, if the hotel provides an accommodation only for the passengers of the enterprise directly connected with their passage and if the costs of that service is included in the passage ticket, this income is treated as transportation income. In such a case, the hotel is treated as a kind of waiting room.

When third parties pay rent to the shipping company under a rent agreement to use all those facilities, the rent is treated as the profits from the operation of the ship and falls within the context of Article 8⁴⁰⁴, but income from these services is a business income of third parties.

Also, the gains from the sale of obsolete aircraft, engines and spare parts of aircraft previously used for international airline activities are exempted from the scope of Article 8⁴⁰⁵.

³⁹⁸ Davies, *op. cit.*, p.142.

³⁹⁹ Vogel, *op. cit.*, p.389.

⁴⁰⁰ The OECD Commentary on Article 8, para. 12.

⁴⁰¹ Such as income from stocks, bonds, shares or loans.

⁴⁰² The OECD Commentary on Article 8, para. 14.

⁴⁰³ *Ibid.*, para.11.

⁴⁰⁴ Vogel, *op. cit.*, p.390.

⁴⁰⁵ Revenue Ruling 72 - 624.

However, profits from the operation of vessels engaged in fishing, dredging or hauling activities⁴⁰⁶ on the high seas will fall within the scope of Article 8, if the countries agree⁴⁰⁷.

Profits from leasing a ship or aircraft on charter - fully equipped, manned and supplied - must be treated as profits from the carriage of passengers or cargo and falls within Article 8⁴⁰⁸.

Income from leasing a ship or aircraft on a bareboat charter is not within the scope of Article 8 except when it is only an occasional source of income for an enterprise engaged in the international operation of ships or aircraft⁴⁰⁹. In this context Article 7⁴¹⁰, concerning business profits, applies to the income from leasing a ship on a bareboat charter.

Profits from leasing a ship or aircraft within the meaning of Article 8 may also cover profits from the cross leasing of spare aircraft between airlines⁴¹¹.

The income from the leasing of containers are within the context of Article 8.

Paragraph 10 of the OECD Commentary on Article 8 states that:

"...profits derived by an enterprise engaged in international transport from the lease of containers which are supplementary or incidental to its international operation of ships or aircraft fall within the scope of this Article".

Is income from the disposition of real estate used in the business activities within the context of international transportation income? Some writers believe that it should be within the scope of international transportation income⁴¹².

⁴⁰⁶ *Supra*, p.95.

⁴⁰⁷ The OECD Commentary on Article 8, para.13 (it is added by 1974 Revised Text).

⁴⁰⁸ *Idem*.

⁴⁰⁹ *Ibid.*, para. 5.

⁴¹⁰ The OECD 1994 Amendments.

⁴¹¹ Even bareboat charters may be included where they are an occasional source of income - for an example of this see, The United States Revenue Ruling 74-170.

Another problem area is income from the sale of ships. This type of income is generally treated as an income from international shipping⁴¹³.

I would submit that the income from sale of the lands and buildings of international transportation companies' should be within the scope of income from international transportation. When international transportation companies have an income from international transportation their ships or aircraft causes the income and there is no reason not to extent this scope to, for example, the ticket sales buildings which are also an important element in the process of selling transport.

However, this situation is different than where assets are disposed of when a business ceases, as it is no longer a transportation business. The income from disposition of assets should not be within the concept of transportation income. However, when the company is still within the transportation business income from selling of the things related with the transportation business should be within the concept of transportation income.

7- The determination of company residence in Model Treaties

The effective management principle is adopted to determine company residence⁴¹⁴ in the OECD and United Nations Models. This is considered particularly for the taxation of income from shipping, inland waterways transport and air transport⁴¹⁵.

The OECD Model Article 4 about residency states that:

"1- For the purposes of this Convention the term 'resident of a Contracting State' means any person, who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, place of management or any other criterion of a similar nature. But this term does not include any person

⁴¹² Herbert Lazerow: "Shipping Exemptions, Realty, and Treaties", *The International Tax Journal*, Vol.17(1990), No.1, p.31.

⁴¹³ See, the United States treaties with Belgium, Finland and Japan.

⁴¹⁴ For the determination of company residence in four sample countries see, *infra.*, p.115.

⁴¹⁵ The OECD Commentary on Article 4, para.23.

who is liable to tax in that State in respect only of income from sources in that State or capital situated therein.

...

3- Where by reason of the provisions of paragraph 1 a person other than an individual is a resident of both Contracting States, then it shall be deemed to be resident of the State in which its place of effective management is situated."

The only difference between the OECD and the United Nations Model is that the United Nations Model does not have the second sentence in paragraph 1 of the OECD Model. The reason is given under the United Nations Model Commentary on Article 4 that "If one of the Contracting States taxed income solely when it arose from domestic sources, and did not tax income from foreign sources, the inclusion of the second sentence in any convention to which it was a party might result in all residents of that country being characterized as non-residents for the purposes of the convention, as a result being deprived of its benefits."

A dual residence is an important problem for the determination of company residence. When a company has dual residence, it would be subject to tax on its income in both countries, which is not a situation that companies wish to be within. It is possible to say that dual residency occurs in two different situations. First, if two countries apply different tests and there is no tie-breaker clause in a double taxation agreement, the company will be a dual resident.

When a company has dual residence usually a double taxation agreement between the two countries will decide the residence of the company⁴¹⁶. This rule is called a tie-breaker clause⁴¹⁷. In the absence of a tie-breaker rule the company will remain

⁴¹⁶ M. Roger Moore: "Dual Resident Companies - The Last Remaining Benefit?", *European Taxation*, Vol.31(1991), No.4, p.94; For the comparison of the position in the United States and the United Kingdom see, Paul D. Yerbury: "Dual Resident Companies - Do they still have a Place in the Tax Planning of Multinationals?", *International Business Lawyer*, April-1987, pp.158-159.

⁴¹⁷ The OECD Model, Article 4(3).

resident in both states and in this situation the company is called "treaty dual resident"⁴¹⁸.

A tie-breaker rule⁴¹⁹ is placed in the 1992 OECD Model Convention which is to the effect that a dual resident company is deemed to be a resident of the state in which its place of effective management is situated. However, in the United States Model the place of incorporation has been adopted as the tie-breaking place of residence for dual resident companies.

Second, under national laws of two contracting states the company may be dual resident. In this case there are two possibilities:

1- One of the countries claim that the company is dual resident. For example, if a company is incorporated in Canada but has management in Canada and the United Kingdom, the United Kingdom can say that company has dual residence, in the United Kingdom and in Canada.

2- Two countries could claim that the same company is resident in their country. For example, if the company is incorporated in the United Kingdom and has management in Canada, it will be dual resident as far as this concept is concerned.

This is a difficult situation to find the residence of the company. For example, if under the double taxation agreement between two countries the effective management principle is adopted as a tie-breaker rule, to find the place of effective management is problematic. Although there are several possibilities to find the place of effective management of the company, a tie-breaker rule not a sharp or sudden solution to the situation. To avoid the possible long process of finding the place of effective management some unilateral relief could be a solution.

If the second possibility happens, for example, if a company incorporated in country X and has the place of effective management in country Y, it could be difficult

⁴¹⁸ David Southern: "Dual Residence and the Non Obstante Rule", *European Taxation*, October/November 1994, pp.438-440.

⁴¹⁹ The OECD Model Convention - 1992, Article-4.

to find the residence of the company. If there is no double taxation between two countries, the problem becomes more difficult. One of the possible solution could be the unilateral relief for the prevention of double taxation.

8- The meaning of the term “permanent establishment” in Model Treaties

The term "permanent establishment" can be problematic since all countries naturally wish to broaden the concept of the term to increase tax revenues. In order to determine what is meant by "permanent establishment" one can either create a list of all activities which constitute having a permanent establishment, or merely depend on basic case law principles.

The term "permanent establishment" is important because sometimes an international transportation company may be subject to tax in different jurisdictions when it has permanent establishments in those jurisdictions. In this case the company would be faced with the multiple taxation. This situation is especially likely for international transportation companies by virtue of the nature of the business.

Most of the countries use the same principles as the Models in their double taxation agreement when defining permanent establishment. The United Kingdom does not use permanent establishment in its national legislation and therefore, the OECD Model's permanent establishment rules apply.

The term "permanent establishment" means in the OECD, United Nations and United States Models Article 5, a fixed place of business through which the business of an enterprise is wholly or partly carried on⁴²⁰.

As seen, the Models have three requirements for the existence of a permanent establishment of an enterprise⁴²¹:

- 1- The existence of a place of "business".
- 2- Such place of business must be fixed.
- 3- The carrying on of the enterprise through this fixed place of business.

⁴²⁰ The OECD Model, Article 5(1).

⁴²¹ The OECD Commentary on Article 5, paragraph-2; Also see, Nathan Boidman - Bruno Ducharme, *Taxation in Canada-Implications for Foreign Investment*, Kluwer, Deventer-1985, p.171.

The first requirement in determining the existence of permanent establishment is a “place of business”. Under Article 5(2) of all the Models the following are treated as permanent establishments:

- a place of management;
- a branch;
- an office;
- a factory;
- a workshop;
- a mine, oil or gas well, quarry, or any other place of extraction of natural resources;

In the United States Model:

- 1- an installation, drilling rig, or ship used for exploration or exploitation of natural resources; and
- 2- a building site or construction or installation project

are also within the concept of the term permanent establishment⁴²² if it is established for more than 12 months.

The OECD Model also includes the item no.2 above⁴²³.

The United Nations Model includes the followings as a permanent establishment⁴²⁴:

- 1- A building site, a construction, assembly or installation project or supervisory activities in connection therewith, but only where such site, project or activities continue for a period of more than six months;
- 2- The furnishing of services, including consultancy services, by an enterprise through employees or other personnel engaged by the enterprise for such purpose, but only where activities of that nature continue (for the same or a connected project)

⁴²² Article 5(3).

⁴²³ Article 5(3).

⁴²⁴ Article 5(3).

within the country for a period or periods aggregating more than six months within 12-month period.

Also, the Nordic Convention⁴²⁵ adopted the following paragraph⁴²⁶:

"A building, construction, installation or assembly project, or activities consisting of planning, supervising, consulting or other auxiliary work by personnel connected with such a project, constitute a permanent establishment, but only if the project or the activities last more than 12 months in a Contracting State."

The main problem of the models is to establish what is really meant by those terms, for example, whether it really is an office in the sense intended. Also, the 12 months rule presents problems in establishing the precise time for the beginning and ending of exploration⁴²⁷.

Certain activities according to Article 5(4) of the OECD, United States and the Nordic Convention do not constitute a permanent establishment. These are:

- a- the maintenance of a facility solely for the purpose of storage, display or delivery of merchandise belonging to the enterprise;
- b- the maintenance of a stock of goods owned by the enterprise solely for storage, display, or delivery;
- c- the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;
- d- the maintenance of a fixed place of business solely for the purpose of the purchasing goods, or collecting information, for the enterprise;

⁴²⁵ The Convention Between The Nordic Countries For The Avoidance Of Double Taxation With Respect To Taxes On Income And Capital, 12.9.1989, *Bulletin for International Fiscal Documentation*, August/September-1990, pp.438-452.

⁴²⁶ Article 5(3).

⁴²⁷ Dale L. Davison: "Agent as Permanent Establishments: Avoiding the U.S. Income Tax for Foreign Businesses", *Taxes*, February-1996, p.103.

- e- the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity⁴²⁸ of a preparatory or auxiliary character; and
- f- the maintenance of a fixed place of business solely for any combination of activities mentioned above.

The United Nations Model is in identical terms with the exclusion of paragraph f.

It is provided by some models, including United States Model Article 5(6), that if an enterprise carries on business through a broker, general commission agent, or any other agent of independent status, and if such broker or agent is operating in the ordinary course of their business, permanent establishment does not exist⁴²⁹. Unfortunately, this formulation could be an invitation for foreign corporations to avoid domestic income tax⁴³⁰.

In the Models, the fixed place of business is the second requirement for the existence of a permanent establishment. The OECD Model Convention Commentaries states that⁴³¹, "*...there has to be a link between the place of business and a specific geographical point...*", although no element of the place of business need be actually fixed to the ground and could be constituted by a caravan for example. However, the place of business should not be set up for temporary purposes. Otherwise no time limit is considered⁴³².

The third requirement for determination of permanent establishment in the Models is that, the business must be carried on through the fixed place of business to constitute a permanent establishment. Under the Commentary on Article 5⁴³³, this means that "*...persons who in one way or another, are dependent on the enterprise (personnel) conduct the business of the enterprise in the State in which the fixed place is situated.*"

⁴²⁸ In the United States Model it is "the activities".

⁴²⁹ The United States Model Treaty, Article 5(6).

⁴³⁰ Davison, op. cit., p.104.

⁴³¹ The OECD Commentaries on Article 5, para.5.

⁴³² Ibid., para.6.

⁴³³ Ibid., para.2.

Some factors could be considered for carrying on business through a fixed place of business such as the existence of an agent, substantial machinery or equipment or an office.

If a corporation has an employee or agent - but not a commission agent, broker or other independent agent - established in a particular place with general authority to contract on behalf of the corporation, that corporation is deemed to have a permanent establishment⁴³⁴.

Also, when the employee or agent, broker or agent regularly orders the corporation's stock, the corporation is deemed to have a permanent establishment. However, if the corporation has no stock of goods in a province it is not deemed to have a permanent establishment there. This rule applies to the company when the goods are coming from another source out of the province which are by mail orders or catalogue sales⁴³⁵.

When an independent agent is working with the company it does not constitute a permanent establishment for the company, because the agent is acting in the ordinary course of his or her own business. The independent agent in the OECD Model is a broker, general commission agent or any other independent agent. The question here is what level of dependency in the relationship between the company and agent will prevent the agent from being independent.

Article 5(5) and (6) of the OECD Model states:

"... where a person - other than an agent of an independent status... - is acting on behalf of an enterprise and has, and habitually exercises, in a Contracting State an authority to conclude contracts in the name of the enterprise, that enterprise shall be deemed to have a permanent establishment in the State in respect of any activities which that person undertakes for the enterprise, unless the activities of such person are limited to those mentioned in paragraph 4 which, if exercised through a fixed place of business, would not make this fixed

⁴³⁴ The Revenue Canada Taxation - Interpretation Bulletin, No.177R2, 4.5.1984, p.2; Davison, op cit., p.102.

⁴³⁵ The Revenue Canada Taxation - Interpretation Bulletin, No.177R2, 4.5.1984, p.2.

place of business a permanent establishment under the provisions of that paragraph."

"An enterprise shall not be deemed to have a permanent establishment in a Contracting State merely because it carries on business in that state through a broker, general commission agent or any other agent of an independent states, provided that such persons are acting in the ordinary course of their business."

A dependent agent without authority to contract on behalf of the company does not constitute a permanent establishment. Also, consignment agreements⁴³⁶ does not indicate the existence of permanent establishment.

CONCLUSION

a- Types of transportation

As we have seen, the OECD and the United Nations Models are not adequate to cover all the problems regarding taxation of profits from international transportation, for example, the definition of international traffic does not include all kinds of transportation.

Although the headline of Article 8 in both Models is "international transportation", the article only covers shipping and air transportation. Land transportation, which includes road and rail transportation, and pipeline transportation are not covered by the article, despite the fact that they are dealt with in many double taxation agreements.

The context of Article 8 should be broad to include other types of transportation as in the Andean Pact Article 8. Interestingly, the OECD Commentaries on Article 3(1)(d) states that the term international traffic is broader than the term normally signifies.

⁴³⁶ An agreement to pay only for what is sold and returns what is unsold.

If we consider this explanation all types of transportations must be within the concept of Article 8. However, Article 8 itself has limited the concept of international transportation to cover only shipping, inland waterways transport and air transport.

The Models need changes in Articles 8 and 3(1)(d) to include all types of transportation since the commentaries have a wider application. Furthermore, the heading of Article 8 would change to "International Transportation".

In practice, many countries include all types of transportation in their double taxation treaties⁴³⁷. For this reason, this change is necessary. Even in some double taxation agreements countries themselves have changed the heading of Article 8. For example, under the United Kingdom - Turkey double taxation agreement⁴³⁸ the heading is "international transportation".

Also, it is difficult to understand why the United Nations Models differentiates between sea and air transportation in Articles 8A and 8B by using the source principle for shipping only⁴³⁹. Although the main purpose was to satisfy the needs of developing countries, Article 8 is limited to shipping and does not include air transportation. It would have been more satisfactory had it extended the context to include air transport.

Although developing countries may have some sort of shipping fleet, generally they do not have a developed air transportation system. Developed countries have well developed air transportation systems and therefore, they prefer to use the residence principle. However, huge differences exist between developing countries. Some developing countries have quite developed air transport systems, Turkey being one example.

This option in the United Nations Model should be extended into other Models to make different possibilities for countries which want to enter into a double taxation agreement.

⁴³⁷ *Supra.*, p.92.

⁴³⁸ *Infra.*, p.196.

⁴³⁹ *Supra.*, p.90.

b- The taxation principles and reciprocal exemption

Although in the OECD and the United Nations Model the effective management principle is offered for international transportation income, in many double taxation agreements the residence principle is preferred by the signatory countries.

The reason could be that when the place of effective management can be in a developing country, developed countries cannot tax this income. However, in most cases the place of effective management is within a developed country. This should be a reason for some developing countries, for example Turkey, to apply residence principle rather than effective management principle.

In agreements between developed countries of similar economic strength the residence principle can be accepted without any great advantage or disadvantage to other party. However, in an agreement between a developed country on the one hand and a developing country on the other, it is to the advantage of the developed country to adopt the residence principle.

When developed countries have their place of effective management in other countries, the adoption of the place of effective management principle is not sufficient to allow income from international activities to be taxed. For this reason, they prefer to use the residence principle which is, in general, the main principle adopted in the OECD Model.

The tendency to use the residence or the effective management principle is not only seen in developed countries but also in some developing countries especially in agreements with other developing countries. It is quite clear that the economic power, even between two developing countries, is an important consideration when entering into double taxation agreements.

Also, differences between developed and developing countries can be seen in reciprocal exemption⁴⁴⁰. Although there may not be much difference when two developed countries apply the reciprocal exemption, there may be a sizeable difference

⁴⁴⁰ *Infra.*, p.243.

with the application of reciprocal exemption between a developed and a developing country since developed countries may have a large amount of income from international transportation in a developing country which is subject to reciprocal exemption.

Developing countries usually do not have as much income from international transportation as developed countries. In this case the reciprocal exemption is tantamount to a loss of tax revenue for a developing country.

c- Definition of international transportation

A clear definition of international transportation is necessary in order to tax profits from international transportation as otherwise many conflicts will arise for the determination of the concept of international transportation .

This definition must include all types of transportation. It is submitted that the following definition can replace the existing ones in the Models:

"For the purposes of this Convention, the term "international transportation" means any transport which takes place between two or more countries in air space, land or water."

d- Profits from international transportation

The definition of profits from international transportation is also problematic. Because of the difference in activities connected with international transportation, it is difficult to decide which activities are within the context of the definition.

When international transportation takes place there are many ancillary activities such as to the supply of food to the passengers or carrying goods to or from the vessel. It is difficult to make a list which would cover all the activities during transportation.

For example, if the ticket price includes some activities it would be possible to say that these activities are within the concept of international transportation. When passengers pay for their ticket and if it includes a stay in a hotel overnight this income

from the hotel facilities is considered within the concept of Article 8. Also, if the hotel is operated by the transport company the same conclusion can be reached.

One must examine the nature of transportation. When international transportation takes place those activities which are closely related to the operation should be within the concept of the term "international transportation" such as hotel facilities for transit journeys or meals within the aircraft.

For this reason, every single activity related to international transportation such as leasing, depot, maintenance, catering, ground handling, hotels, restaurants, snack bars, shops, ship-building yards can cause difficulties in terms of determining which profits are from international transportation, and whether they are within the concept of international transportation should be determined.

e- Types of vessel

The type of the vessel is also important in determining whether the profits from that vessel fall within the definition of international transportation⁴⁴¹. Although some types of vessels are not covered by the Article 8 as it noted in the Commentaries, countries can agree on which types of vessels are within the scope of Article 8.

In international transportation any types of vessel can be used. For this reason, it is difficult to understand why fishing vessels are not within the scope of Article 8. It is possible for countries to decide that fishing vessels are within the scope of Article 8 but this is not the point. When a fishing vessel carries goods or even passengers it should be within the scope of Article 8.

In other word, if a vessel carrying goods or persons it is not important if it is a floating dock. It is used for transportation and it should be within the scope of Article 8.

Since there is no definition in the OECD and the United Nations Models for the terms "ship" or "aircraft" either a definition can be adopted or the terms can be interpreted broadly under the heading of Article 8.

⁴⁴¹ Supra., p.92.

The heading of Article 8 is "shipping, inland waterways transport and air transport" and within the text "operation of ships or aircraft" and "operation of boats engaged in inland waterways transport" have been used. Shipping here is a general term for transportation on the water and includes all types of vessels.

Also, the same explanation can be given for the "inland waterways transport" which is the heading of Article 8. However, in the text only "boat" has been mentioned. The people who prepared the text may have thought that transportation on inland waterways could take place in boats and no other types of vessel.

For this reason, the term "vessels" should have been used within the text of Article 8 to cover not only "ship" or "boat" but all types of shipping and inland waterways transportation. With small change within the context of Article 8 the problem can be solved. The term "operation of ships" would change into "operation of vessels for shipping"; and "operation of boats engaged in inland waterways transport" would change into "operation of vessels engaged in inland waterways transport".

The inadequacy of the OECD and the United Nations Models to cover all possible international transportation activities and establish the meaning of the terms exacerbates the problem. Even if commentaries are often not sufficient to solve the problem.

Although the numerous double taxation treaties between countries, and the various models, acts, codes, regulations and court decisions offer definitions and explanations of what constitutes activities that could come under the term "international transportation", it may seem desirable to attempt to draw up a list of all the activities that fall under the term.

Such a list could end the confusion of the concept of the terms "international transportation" and "international transportation income". However, it would not be easily compiled because of the immense scope of activities carried out.

Indeed, although the definition may be welcomed by taxing authorities, transportation companies would prefer not to have a detailed list of the activities to prevent the tax authorities from broadening the scope of the term "international transport". A list drawn up by a third party would probably not find wide acceptance by either the tax authorities or the transportation companies.

It is probably best to leave the question of determining the status of these activities to the courts in the hope that there will evolve an ever clearer definition of the nature and scope of the term "international transportation".

PART III: TAXATION OF INTERNATIONAL TRANSPORTATION COMPANIES' INCOME IN FOUR SAMPLE COUNTRIES

INTRODUCTION

International aviation and shipping is potentially subject to multiple taxation due to the fact that international journeys may have multiple embarkation and disembarkation points each of which may be in a different tax jurisdiction. Although double taxation agreements and models deal with the problem, national legislations are also important since they use different tax principles to tax international transportation profits.

For this reason, in this part of the thesis the national legislation of four countries Canada, Turkey, the United Kingdom and the United States are examined in terms of international aspects of the taxation of international transportation companies' income.

This examination shows that all four countries have different legislation and regulations in the field of international transportation. This is the result of different approaches taken to international transportation in the light of national problems. However, they have some similarities especially related to some problems, such as the concept of international transportation.

CHAPTER V: CANADA

1- Introduction

In Canada, for international transportation companies three forms of reciprocal exemption may be available⁴⁴² for the avoidance of double or multiple taxation:

- 1- Unilaterally at the national level (paragraph 81(1)(c) of the Canadian Income Tax Act⁴⁴³),
- 2- Through international transport agreements⁴⁴⁴,
- 3- Through double taxation conventions⁴⁴⁵.

The Income Tax Act of Canada⁴⁴⁶, imposes tax on the taxable income for each taxation year of every person who is resident⁴⁴⁷ in Canada at any time in the year⁴⁴⁸. Therefore, Canadian resident transportation corporations are subject to Canadian tax system on their worldwide income. If the taxpayer has no residence in Canada, only Canadian source income is taxed.

⁴⁴² Daniel Lang: "Taxation of International Aviation: A Canadian Perspective", *Canadian Tax Journal*, Vol.40(1992), No.4, p.882.

⁴⁴³ SC-1926, C.10, Section 10.

⁴⁴⁴ With Argentina, CTS-1949/5; India, CTS-1982/9(only air transport); Israel, CTS-1966/23; Republic of Korea, CTS-1974/36. All of them exempt aviation and shipping profits, despite they are not double taxation conventions.

⁴⁴⁵ With Barbados, Belgium, Chine, Cuba, Czechoslovakia, Haiti, India, Israel, Jamaica, Morocco, the Netherlands, Poland, Romania, Singapore, Saint Kitts and Nevis, Saint Lucra, Switzerland, Trinidad and Tobago, USSR and Yugoslavia.

⁴⁴⁶ RSC 1952, C.188, as amended by SC 1970-1971-1972, C.63. It was introduced in 1945. SC-1945, C.23, Subsection 2(1). It was based on the exception for international shipping (Hereinafter referred as ITA).

⁴⁴⁷ *Infra*, p.125.

⁴⁴⁸ ITA, Subsection 2(1).

"*Canadian source income*" in this context means income from carrying on a business⁴⁴⁹ in Canada. For this reason, transportation corporations are taxed on income earned from carrying on a business in Canada.

In Subsection 248(1) of the Income Tax Act, the term "*business*" includes a profession, calling, trade, manufacture, or undertaking of any kind whatever, and an adventure in the nature of trade⁴⁵⁰.

In Canada, the federal corporate income tax rates are 28.84% for general business, 21.84% for manufacturing and processing profits and 12.84% for general small business.

2- Canadian Double Taxation Treaties

In 18th century Canadian shipbuilding industry began to develop to exploit their wood resources. They were ranked fourth in the world with more than 7000 vessels before steel replaced wood in the shipping industry⁴⁵¹.

This notwithstanding, Canada was relatively late in entering international double taxation treaties. It has been speculated that this is not because of any unwillingness on the part of Canada to enter such agreements, but more to do with the lack of senior staff in the relevant area of administration in Canada, and the absence of approaches to Canada by other jurisdictions. From 1926, non-resident transportation companies' income from the operation of a ship or aircraft were exempted from income tax on a reciprocal basis⁴⁵².

In 1928, Canada entered into its first tax treaty⁴⁵³ which concerned the taxation of shipping profits with the United States⁴⁵⁴. Subsequently, it signed 11 treaties between

⁴⁴⁹ See, John Durnford: "The Distinction Between Income from Business and Income from Property, and the Concept of Carrying on Business", *Canadian Tax Journal*, Vol.39(1991), No.5, pp.1180-1205; G.M. Keyes: "Carrying on Business in Canada", *Canadian Tax Journal*, Vol.10(1962), pp.41-50.

⁴⁵⁰ *Infra.*, p.152.

⁴⁵¹ Allan R. Lanthier, "Incentives for International Shipping Corporations", *Bulletin for International Fiscal Documentation*, June-1991, p.269.

⁴⁵² Ernest H. Smith: "Making Canada's Tax Treaties", *Canadian Tax Journal*, Vol.10(1962), pp.290-291.

⁴⁵³ By the exchange of notes 2.8.1928 and 17.9.1928.

1928 and 1932 regarding the avoidance of double taxation of shipping profits and 4 more including aircraft profits before 1942⁴⁵⁵.

Those agreements were concluded by Exchange of Notes. Under this system, the negotiations carried on through diplomatic channels, and after the exchange of notes between the two countries, the agreement was brought into force and it was not necessary to wait for Parliamentary approval⁴⁵⁶.

Canada also signed other agreements before 1942: with New Zealand concerning the avoidance of double taxation of profits or gains arising through an agency; with the Netherlands' Indies, concerning the avoidance of double taxation on income; with France, concerning the application of the French national solidarity tax to Canadian nationals and corporations; and with the United Kingdom in 1935, regarding avoidance of double taxation of gains made through an agency and with the United States concerning rates of income tax related with non-resident individuals in 1936.

Canada entered its first comprehensive tax⁴⁵⁷ treaty with the United States in 1942 and with the United Kingdom in 1946, that extended the prior agreement to 29 British Colonies.

Until the major 1971 income tax amendments, which took effect as of 1.1.1972, Canada had signed tax treaties with 18 states. Most of them were concluded before 1963 OECD Draft Model Treaty. From 1971-1977, Canada concluded 12 new treaties and were in the process of negotiating 23 new treaties. In comparison, by the end of 1972, the United Kingdom had signed 66 tax treaties and the United States 34 tax treaties⁴⁵⁸. By 1996 Canada has concluded 55 tax treaties.

In Canada separate legislation is needed for each tax treaty for incorporation⁴⁵⁹.

⁴⁵⁴ Alexander J. Easson: "The Evolution of Canada's Tax Treaty Policy Since the Royal Commission on Taxation", *Osgoode Hall Law Journal*, Vol.26(1988), No.3, p.496; D.H. Moore: "Treaties: Effects on Residents and Non-Residents" in W.A. Macdonald-G.E. Cronkwright, *Income Taxation in Canada*, Prentice-Hall Canada Inc., Ontario-1986, Vol.5, p.70,002-5.

⁴⁵⁵ Smith, op. cit., p.294.

⁴⁵⁶ Idem.

⁴⁵⁷ Not limited such as includes only sea and/or air transportation.

⁴⁵⁸ Smith, op. cit., p.294.

⁴⁵⁹ Idem.

Canada has concluded international transport agreements with Argentina⁴⁶⁰, India (only air transport)⁴⁶¹, Israel⁴⁶² and the Republic of Korea⁴⁶³ to exempt non-resident companies' air and shipping profits from taxation in Canada.

The most comprehensive tax agreements of Canada are Canada-United States and Canada-United Kingdom. Under Canada-United States double taxation agreement of 1985, income from the operation of ships, aircraft, motor vehicles or railway is subject to reciprocal exemption⁴⁶⁴. Under Canada-United Kingdom double taxation agreement of 1978, the country of residence of an enterprise has right to tax profits from the operation of shipping and air transport⁴⁶⁵.

Canada uses the effective management⁴⁶⁶ and the residence principle⁴⁶⁷ in double taxation agreements.

Canada reserves the right to tax profits from internal traffic, profits from the carriage of passengers or cargo taken on board at one place in a respective country for

⁴⁶⁰ CTS-1949/5.

⁴⁶¹ CTS-1982/9.

⁴⁶² CTS-1966/23.

⁴⁶³ CTS-1974/36.

⁴⁶⁴ *Infra.*, p.243.

⁴⁶⁵ 8.9.1978. It replaced the double taxation agreement dated 12.12.1966.

⁴⁶⁶ With Belgium-29.5.1975, ETSC 1 No.9(1976), Germany-17.7.1981, ETSC 5 No.12(1991), Ireland-23.11.1966, ETSC 7 No.1(1968), Italy-17.11.1977, ETSC 7 No.5(1989), Luxembourg-17.1.1989, ETSC 8 No.9(1991), Netherlands-27.5.1986, ETSC 8 No.7(1993), Norway-23.11.1966, ETSC 9 No.10(1967) and Poland-4.5.1987, ETSC 9 No.7(1990).

⁴⁶⁷ With Austria-9.12.1976, ETSC 1 No.4(1981), Cyprus-2.5.1984, ETSC 2 No.11(1985), Czechoslovakia-30.8.1990, ETSC 2 No.12(1992), Estonia-2.6.1995, ETSC 3 No.4(1996), Finlandia-28.5.1990, ETSC 4 No.11(1995), France-2.5.1975, ETSC 4 No.10(1996), Hungary-15.4.1992, ETSC 6 No.7(1996), Latvia-26.4.1995, ETSC 7 No.9(1996), Malta-25.6.1986, ETSC 8 No.7(1987), Spain-23.11.1976, ETSC 10 No.4(1981), Sweden-14.10.1983, ETSC 11 No.1(1997), Romania-20.11.1978, ETSC 10 No.4(1981) and Russia-5.10.1995, ETSC 10 No.11(1996).

discharge at another place in the same country⁴⁶⁸. Canada also reserves the right not to extend the scope of the Article to cover inland transportation in bilateral conventions⁴⁶⁹.

Canada has reserved the right when using the OECD Model to use place of incorporation in double taxation agreements as a tie-breaker rule instead of the place of effective management to determine the residence of the corporation. For example, the Canadian double taxation agreements with Finland, Nigeria, Papua New Guinea and the United States.

Interestingly, despite the fact that Canada has made a reservation on the principle in some of the Canada's double taxation agreements where the competent authority has been given the power to determine residence⁴⁷⁰, the "place of effective management" test could be adopted by the competent authority, for example Canadian double taxation agreements with Trinidad and Tobago, in preference to the place of incorporation or organization⁴⁷¹. In this situation the reservation can make the rest of the agreement meaningless since the competent authority can choose to rely on other principles. However, the competent authority can choose any other factors⁴⁷².

For the determination of tie-breaker rules for company residence, the following examples from Canadian double taxation agreements have been given:

"1- Double taxation agreements with Denmark and Ireland do not contain a tie-breaker rule for company residence. In which case, the competent authorities of both contracting states should find a solution.

2- If a company is not incorporated in either state, the place of effective management will be a tie-breaker rule for company residence as expressed under double taxation agreements with Australia and Soviet Union.

⁴⁶⁸ The OECD Commentary on Article-8, para.30; Turkey and the United States have made the same reservation.

⁴⁶⁹ Ibid., para.31.

⁴⁷⁰ See, Canadian double taxation agreements with Argentina, Austria, Barbados, Belgium, Brazil, China, France, Germany, Guyana, India, Indonesia, Italy, Ivory Coast, Jamaica, Japan, Kenya, Liberia, Luxembourg, Malaysia, Malta, Mexico, Morocco, the Netherlands, New Zealand, Philippines, Romania, Singapore, Sweden, Switzerland, Tunisia, the United Kingdom and Zambia.

⁴⁷¹ Kroft, op. cit., p.1:33.

⁴⁷² Supra., p.49.

3- If a company is a national of neither state, the place of effective management will be a tie-breaker rule for company residence as expressed under double taxation agreements with Bangladesh, Cameroon, Cyprus, Dominican Republic, Egypt, Hungary, Israel, Pakistan, Poland, Spain, Sri Lanka, Thailand and Zimbabwe.

4- If a company is not a national of either state, the competent authorities of two contracting states will decide about the residence of the company as expressed under double taxation agreements with Czechoslovakia, Kenya, Liberia and Switzerland⁴⁷³.

3- Taxation of International Transportation Companies' Income

Non-resident companies⁴⁷⁴ carrying on business in Canada and not exempted from taxation in Canada will be taxed under the provisions of subsections 2(3) and 115(1) of the Canadian Income Tax Act.

Subsection 2(3) of the Income Tax Act of Canada states that:

"Tax payable by non-resident persons. Where a person who is not taxable under subsection (1) for a taxation year

- (a) was employed in Canada,*
- (b) carried on business in Canada, or*
- (c) disposed of a taxable Canadian property,*

at any time in the year or a previous year, an income tax shall be paid as hereinafter required upon his taxable income earned in Canada for the year determined in accordance with Division D."

⁴⁷³ Edwin G. Kroft, "Jurisdiction To Tax: An Update" in *Tax Planning for Canada-United States and International Transactions*, Corporate Management Tax Conference-1993, Canadian Tax Foundation, Toronto-1994, p.1.86, Appendix C.

⁴⁷⁴ *Infra.*, p.125.

Subsection 115(1) of the Income Tax Act of Canada states that:

"For the purposes of this Act, a non-resident person's taxable income earned in Canada for a taxation year is the amount of his income for the year that would be determined under section 3 if

(a) he had no income other than

(i) incomes from the duties of offices and employments performed by him in Canada,

(ii) income from businesses carried on by him in Canada,

(iii)...

(iv)...

(v) in the case of a non-resident person described in subsection (2),

the aggregate determined under paragraph (2)(e) in respect of him,

...

minus the aggregate of such of the deductions from income permitted for the purpose of computing taxable income as may reasonably be considered wholly applicable and of such part of any other of the said deductions as may reasonably be considered applicable."

However, for non-resident international transportation companies paragraph 81(1)(c) of the Income Tax Act provides reciprocal exemption as follows:

"There shall not be included in computing the income of a taxpayer for a taxation year,

(c) the income for the year of a non-resident person earned in Canada from the operation of a ship or an aircraft in international traffic, if the country where that person resided grants substantially similar relief for the year to a person resident in Canada. "

Some terms used in paragraph 81(1)(c) require further examination before the details of unilateral exemption are dealt with.

4- Definitions

a- "In Canada"

In paragraph 81(1)(c) "*in Canada*" means the continental shelf and the airspace over the continental shelf⁴⁷⁵. The term includes territorial sea of Canada and the overlaying airspace. In other words, all water and airspace within a 12 nautical mile limit⁴⁷⁶. For income tax purposes, Canada includes the sea bed and subsoil of the submarine areas adjacent to the coasts of Canada (basically Canada's continental shelf)⁴⁷⁷.

The term also includes the seas and airspace above those submarine areas⁴⁷⁸. Any equipment and any personnel that are engaged under upon or above the seas while carrying out certain mining activities⁴⁷⁹ will be considered to be in Canada while so engaged⁴⁸⁰.

b- "Aircraft"

The term "*Aircraft*" means⁴⁸¹ any machine capable of deriving support in the atmosphere from the reactions of the air, other than a machine designed to derive support in the atmosphere from reactions against the earth's surface of air expelled from the machine, and includes a rocket⁴⁸².

⁴⁷⁵ The Revenue Canada-Interpretation Bulletin IT-494, 31.1.1983, article 4.

⁴⁷⁶ *Idem*.

⁴⁷⁷ ITA, Subsection 255(a).

⁴⁷⁸ ITA, Subsection 255(b).

⁴⁷⁹ "That carried on in connection with the exploration for or exploitation of the minerals, petroleum, natural gas or hydrocarbons --in, upon or over any submarine areas-- that the Government of Canada or of a province grants a rights, licence or privilege to explore for, drill for or take any minerals, petroleum, natural gas or related hydrocarbons" in ITA, Subsection 255(b).

⁴⁸⁰ The Revenue Canada-Interpretation Bulletin, IT-494, 31.1.1983, Article 4. For information about Canadian territorial waters see, Appendix A.

⁴⁸¹ See, *supra*, p.92.

⁴⁸² The Canadian Aviation Safety Board Act, Subsection 2(1), 17.11.1983, Status of Canada, Vol.4 (1980-1981-1982-1983).

c- "International traffic"

The term "*International traffic*" is defined in subsection 248(1) of the Income Tax Act that:

"...in respect of a non-resident person carrying on the business of transporting passengers or goods, any voyage made in the course of that businesses where the principal purpose of the voyage is to transport passengers or goods

(a) from Canada to a place outside Canada,

(b) from a place outside Canada, to Canada or

(c) from a place outside Canada to another place outside Canada."

An example of the last category may be the "fifth freedom" flight where the journey passes through a country without terminating there⁴⁸³. The term symbolise a kind of international air service right that one country receives from the other in terms of a bilateral air agreement. When countries are taxing income from fifth freedom flights, the term "international traffic" becomes important.

Under bilateral agreements, each signatory country is permitted to exercise one or more of the following five rights over the territory of the other signatory countries:

1- The privilege to fly across its territory without landing.

2- The privilege to land for non-traffic purposes (e.g. maintenance, refuelling: Canada does not tax refuelling⁴⁸⁴ stops within Canada).

3- The privilege to put down passengers, mail and cargo taken on in the territory of the State whose nationality the aircraft possesses.

4- The privilege to take on passengers, mail and cargo destined for the territory of the State whose nationality the aircraft possesses.

⁴⁸³ Lang, op. cit., pp.891-892 and 900.

⁴⁸⁴ The Convention on International Civil Aviation, Chicago, 7.12.1944, Article 24.

5- The privilege to take on passengers, mail and cargo destined for the territory of any other contracting State and the privilege to put down passengers, mail and cargo coming from any such territory⁴⁸⁵.

It is not necessary that all five freedoms will be included in every agreement. Also, the sixth freedom exists as a supplementary right. The sixth freedom is a mixture of the third and fourth freedoms. Under the sixth freedom flights, an airline of country A carries traffic between two other countries but uses its base at A as a transit point⁴⁸⁶.

Traffic between points on the Great Lakes or St. Lawrence River and other points in Canada will not fall within the definition of international traffic. That is why traffic between United States and Canada on these points will be treated as a traffic within Canada⁴⁸⁷.

d- "Resident"

The Income Tax Act of Canada includes statutory rules⁴⁸⁸ which deem a corporation to have been "*resident*" in Canada throughout a taxation year if

"(a) in the case of corporation incorporated after April 26, 1965, it was incorporated in Canada;

(b) in the case of a corporation that

(i) was incorporated before April 9, 1959,

(ii) was, on June 18, 1971, a foreign business corporation (within the meaning of section 71 of this Act as it read in its application to the 1971 taxation year) that was controlled by a corporation resident in Canada,

(iii) throughout the 10-year period ending on June 18, 1971, carried on business in any one particular country other than Canada, and

⁴⁸⁵ The Statistics Canada, Transportation Division, Aviation Statistics Centre: *Aviation in Canada*, Ottawa-1986, p.202 and p.186 ; Donald H. Bunker, *Canadian Aviation Finance Legislation*, Institute and Centre of Air and Space Law-McGill University, Montreal-1989, p.177.

⁴⁸⁶ Bunker, op. cit., p.177.

⁴⁸⁷ John R. Owen, "Tax Issues in International Shipping", *Canadian Tax Journal*, Vol.41(1993), p.730.

⁴⁸⁸ ITA, Subsection 250(4).

(iv) during the period referred to in subparagraph (iii), paid dividends to its shareholders resident in Canada on which its shareholders paid tax to the government of the country referred to in subparagraph (iii),

it was incorporated in Canada and, at any time in the taxation year or at any time in any preceding taxation year commencing after 1971, it was resident in Canada or carried on business in Canada; and

(c) in the case of a corporation incorporated before April 27, 1965 (other than a corporation to which subparagraphs (b)(i) to (iv) apply), it was incorporated in Canada and, at any time in the taxation year or at any time in any preceding taxation year of the corporation ending after April 26, 1965, it was resident in Canada or carried on business in Canada. "

Additionally, a corporation that is incorporated in a foreign jurisdiction is still considered resident in Canada if the central management and control of the corporation are situated in Canada⁴⁸⁹ and, therefore, subject to Canadian taxation on its worldwide income.

The *Bedford Overseas Freighters Ltd. v. M.N.R.*⁴⁹⁰ is an example of the impact of the central management and control test on shipping operations. In that case, the taxpayer corporation was controlled indirectly by an individual resident in Greece, but had a board of directors in Canada. The Exchequer Court treated the taxpayer as a resident of Canada for the purposes of the Act and concluded that the taxpayer was taxable on his world-wide income, because the individual's directions were followed by his Canadian directors and, therefore, the management of the business was in Canada.

In my opinion, if a person has some businesses in Greece, it is quite normal to be resident there and to send his directions to Canada. Otherwise, all foreign companies that are directed from abroad would have to be treated as a Canadian based companies. As the Committee⁴⁹¹ expressed "non-residents must be able to locate some of their

⁴⁸⁹ S.N. Frommel, *Taxation of Branch and Subsidiaries*, Kluwer, London-1975, p.31; Owen, op. cit., p.724. This test is derived from United Kingdom case law, *De Beers Consolidated Mines Ltd. v. Howe*, (1906) AC 455, p.458; Angelo Nikolakakis: "Canada offers complex system", *International Tax Review*, October-1995, pp.37-38.

⁴⁹⁰ 70 DTC 6072 in Owen, op. cit., p.727, footnote-8.

⁴⁹¹ Transportation Task Force Asia-Pacific Initiative Advisory Committee.

operations in Canada without fear that their currently tax-exempt profits will become subject to tax in Canada"⁴⁹².

However, a foreign corporation is deemed not resident under subsection 250(5) of the Income Tax Act:

"Notwithstanding subsection (4), for the purposes of this Act, a corporation, other than a prescribed corporation, shall be deemed not to be resident in Canada at any time if, by virtue of an agreement or convention between the Government of Canada and the government of another country that has the force of law in Canada, it would at that time, if it had income from a source outside Canada, not be subject to tax on that income under Part I."

Canadian Income Tax Act Subsection 250(6)⁴⁹³, relating to the residence of international shipping companies, states:

"For the purposes of this Act, a corporation that was incorporated or otherwise formed under the laws of a country other than Canada or of a state, province or other political subdivision of such a country shall be deemed to be resident in that country throughout a taxation year and not to be resident in Canada at any time in the year, where

(a) the corporation's principal business in the year consist of the operation of ships that are used primarily in transporting passengers or goods in international traffic (determined on the assumption that the corporation is non-resident and that, except where paragraph (c) of the definition "international traffic" in subsection 248(1) applies, any port or other place on the Great Lakes or St. Lawrence River is in Canada);

(b) all or substantially all of the corporation's gross revenue for the year is from the operation of ships in transporting passengers or goods in such international traffic; and

(c) the corporation has not been granted articles of continuance in Canada before the end of the year."

Subsection 250(6) states that a corporation formed under the laws of a country other than Canada and carrying on an international shipping business is deemed to be

⁴⁹² Owen, op. cit., p.727, footnote-9.

⁴⁹³ Applicable to taxation years after February 1991.

resident in its country of incorporation and not to be resident in Canada if it meets the following tests:

1- The corporation's principal business in the taxation year must consist of the operation of ships used by the corporation primarily in transporting passengers or goods in international traffic, and

2- All or substantially all of the corporation's gross revenue for the year is derived from its international shipping business⁴⁹⁴.

Accordingly, subsection 250(6), a foreign corporation will not be considered to be a resident of Canada even though all its management and operational personnel and also board of directors is in Canada⁴⁹⁵.

The practical issues relating to residence of the foreign corporations in Canada has been summarised at a 1993 Tax Conference as follows:

"In today's context, the key question regarding corporate residence, particularly in the case of the wholly owned foreign subsidiary, is at what point the non-Canadian directors have either given up their statutory right of control or are sharing it with Canadians so as to result in a court finding that the company is resident in Canada. As in most instances, the extreme fact situations present little problem. Where the board of directors has totally abdicated its responsibilities in favour of someone else, the residence of the company will be located where the decisions were in fact being made.

The determination of residency becomes interesting where the board of directors goes through the paces - that is, satisfies its statutory requirements regarding meetings, corporate filings, and financial statements, etc. - but has to a greater or lesser extent, permitted the general policy of the corporation to be established by someone else.

Despite the simplicity of the original test of corporate residence, there are divergent lines of jurisprudence dealing with the degree of

⁴⁹⁴ Owen, *op. cit.*, p.729.

⁴⁹⁵ *Idem.*

central management and control that must be located in a jurisdiction before residence can be established. One test merely requires that some part of the superior and directing authority of the corporation be present and that it is not necessary to locate the place where final and supreme authority resides. For example, if a majority of the directors met in country A and a minority of the board met in country B, dual residency would be established.

The other more stringent test requires that the location of the final and supreme authority be determined as the corporate residence. To find dual residence under this criterion, it is necessary to find that the final and supreme authority is in fact divided between two jurisdictions so as not to be located in any one of them.

If one of the two locations is paramount, there would not be dual residence. In the hypothetical situation outlined above there would not be dual residence under this test. The company would reside in country A where the majority of the board, representing supremacy, held the meetings."⁴⁹⁶

Canada applies two tests, the "incorporation" test and the "central management and control" test. These two tests apply separately. If a company is incorporated in one of the above countries it will be resident of that country and the other test does not apply. If two tests apply to the same company at the same time, it leads to dual residence.

To apply the first test does not constitute any problem. If a company is incorporated in Canada⁴⁹⁷ it becomes resident in. The problem appears when the "central management and control" test is applied to find the real place of central management and control⁴⁹⁸.

In the application of these principles to Canada, under the "central management and control" test the taxpayer is deemed to be resident in Canada. If the corporation's

⁴⁹⁶ By Bernard Morris in Kroft, op.cit., pp.1:27-1:28.

⁴⁹⁷ Supra., p.123.

⁴⁹⁸ See, Malcolm J. Gammie, "Non-Resident Companies", I-II-III and IV, *Taxation*, 4.2.1978 - 18.2.1978 - 4.3.1978 and 18.3.1978.

board of directors meets in Canada, the meetings indicate that the central management and control is located in Canada⁴⁹⁹.

Some principles suggested⁵⁰⁰ for the determination of residence of the company in Canada are:

1- A corporation is resident where its real business is carried on or a corporation's real business is carried on where its central management and control abides.

2- The place where directors meet and exercise their power to manage the business of a corporation determines the location of central management and control.

3- The place of actual exercise of the power which is given by the law will determine the location of central management and control. In this context the question is whether the directors abdicate their power.

4- In Canada, the determining factor for dual residence is not clear and there is no comprehensive statement.

However, to find the place of actual exercise of the power is difficult since it is based on the company's extensive business relations.

The following observation is interesting for the attitude of the Revenue Canada on non-resident status of corporations:

"It is understood that Revenue Canada does not generally, as an administrative practice, challenge the non-resident status of foreign corporations incorporated and taxable in high tax foreign jurisdictions even where the management of such corporation takes place in whole or in part in Canada.

Revenue Canada's attack on the resident status of foreign corporations is more likely to occur where a Canadian shareholder

⁴⁹⁹ Julie Y. Lee - Scott L. Schuerman: "Establishing a Foreign-Owned Business in Canada", *The Journal of International Taxation*, September-October-1990, p.177.

⁵⁰⁰ Boidman-Ducharme, op. cit., p.43.

establishes a foreign corporation in a country considered to be a tax haven. A successful attack on a tax haven corporation can yield significant tax increases if Revenue Canada is able to tax income that has not suffered a foreign tax and for which no foreign tax credit would be available to offset the Canadian tax otherwise payable.

Alternatively, Revenue Canada may take the position that the foreign corporation is a sham and, therefore, should be disregarded for tax purposes. If successful, this approach has the effect of attributing the income of the corporation to the Canadian resident who controls the corporation and renders the Canadian resident liable for the tax. Obviously, Revenue Canada has fewer tax enforcement difficulties on this approach.⁵⁰¹

The international corporation can be deemed non-resident when the following activities take place outside Canada⁵⁰²:

- 1- meetings of the board of directors;
- 2- the signing of legal and business documents;
- 3- corporate banking;
- 4- the address and telephone numbers;
- 5- accounting and bookkeeping activities;
- 6- the residence of people with signing, contracting, and decision-making authority;
- 7- sales or other business activities; and
- 8- the undertaking and execution of legal guarantees.

However, such factors as listed above can take long time to search, especially in the case of larger companies.

If the meetings of the board of directors take place outside of Canada, the company would not be subject to tax in Canada because of its residency status. When an international transportation company wishes not to be resident in a given country to avoid being subject to tax, its directors meetings could be held in a tax haven country such as a flag-of-convenience country. This could be relatively easy to establish from the

⁵⁰¹ Kroft, *op. cit.*, p.1:30.

⁵⁰² By Marcel Racicot in *ibid.*, p.1:31.

point of view of an international transportation company since such countries want to attract foreign corporations⁵⁰³.

However, if a director is a resident of the given country rather than the tax haven country and merely sends his instructions to the tax haven country, it may be determined that the company is resident in the given country.

The *Crown Forest Industries Limited v. The Queen*⁵⁰⁴, is an important case for the determination of residency in Canada⁵⁰⁵. In this case a Canadian taxpayer, Crown Forest rented barges from Norsk Pacific Steamship Company Limited which was a Bahamian corporation working in the field of international shipping. The Norsk's only office and place of business was in the United States.

Norsk was considered a foreign corporation in the United States since it was incorporated in Bahamas and exempt from United States income tax. The important point for the company was to establish the United State residence to allow the company reduction of tax by withholding at 10 per cent under the Canada-United States treaty⁵⁰⁶, rather than at the rate of 25 per cent applicable to non-residents.

The definition of "resident" in Canada-United States Income Tax Convention is "*...any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, place of management, place of incorporation, or any other criterion of a similar nature...*"

The OECD Model adopts a virtually identical definition which differs from the above in two respects only. First, the term "place of incorporation" is not mentioned. However, it is difficult to understand why the Canada-United States convention includes the term "place of incorporation". The reason may be that the Canadian negotiators and

⁵⁰³ By Michael O'Keefe in idem.

⁵⁰⁴ (1995), 2 S.C.R. 802, <http://www.droit.umontreal.ca/Dro...ets/1995/vol2/ascii/forest.en.txt>.

⁵⁰⁵ For details see, Jack Bernstein: "Residence Determines Canadian Tax Liability in Recent Cases", *The Journal of International Taxation*, July-1993; Francois Vincent: "Crown Forest Industries: The OECD Model Tax Convention as an Interpretive Tool for Canada's Tax Conventions", *Canadian Tax Journal*, Vol.44(1996), No.1, pp.38-58; David A. Ward and Others: "A Resident of a Contracting State for Tax Treaty Purposes: A Case Comment on Crown Forest Industries", *Canadian Tax Journal*, Vol.44(1996), No.2, pp.408-424.

⁵⁰⁶ The Convention Between Canada and the United States of America with Respect to Taxes on Income and on Capital, 26.9.1980 amended by the protocols signed on 14.6.1983 and 28.3.1984, Article 12(2).

the drafters felt comfortable with this expression because the term had been used in many Canadian treaties before the Canada-United States convention⁵⁰⁷.

Second, the OECD Model Article 4(1) also contains a second sentence which has importance for the case as follows:

"But this term does not include any person who is liable to tax in that State in respect only of income from sources in that State or capital situated therein."

This second sentence was added to the OECD Model text in 1977 and is intended to apply to the special situation of foreign diplomats and consular staffs who may be subject to limited source taxation in their foreign postings. The sentence is included in the 1981 United States Model but is not in use in most of the Canadian tax treaties.

Also, the United Nations Model does not have this second sentence. According to the commentary, the sentence could have a broader impact, because where a contracting state taxes income solely when it arises from domestic sources, the inclusion of the second sentence might result in all residents of that country being characterised as non-residents for the purposes of the convention⁵⁰⁸.

According to the Federal Court of Appeal⁵⁰⁹, the omission indicated that the drafters did not intend to make liability to tax on a world-wide basis a condition for residency status under the Canada-United States convention.

The use of the OECD Model was very important for the interpretation of the treaties regarding residence of company. The situation has been explained in the following words:

"...the majority's⁵¹⁰ reference to the missing sentence in the Convention as compared to the OECD Model is a very compelling technical argument in favour of the decision reached. Unless some convincing rationale can be offered for this difference, the majority

⁵⁰⁷ Vincent, op. cit., pp.44-45, footnote-21.

⁵⁰⁸ Ward and Others, op. cit., p.411 footnote-4.

⁵⁰⁹ Supra., footnote-504.

⁵¹⁰ The majority of the Court.

finding will likely stand. It seems unlikely that the Supreme Court would entertain an appeal or overturn a decision based solely on the argument that United States tax liability did not arise by reason only of the place of management being in the United States.

This clause may have been omitted from the Canadian and United States treaty models because they felt it inappropriate to have such a clause in treaties with countries that tax on a territorial basis. They may also have felt that the wording of the first sentence was sufficient to convey the extensive link required between the entity and the residence country. In particular, they may have felt that the expression 'place of management would be interpreted more along the lines of 'central management and control'. It appears likely that a legislative fix or Protocol amendment will be required to correct the situation."⁵¹¹

Although the Minister of National Revenue stated Norsk was not resident in the United States and subject to 25 per cent tax, the Federal Court Trial Division concluded that Norsk was a "resident" of the United States within the meaning of Article 4(1) of the Canada-United States treaty and the company was subject to reduced tax rate under United States law.

After this decision the Minister of Revenue Canada applied to the Federal Court of Appeal claiming that two errors had been made. The first error related to the decision that Norsk's United States tax liability was posited on its having a trade or business which is effectively connected with the United States, and not on the company's place of management being located in the United States.

The second error concerned the application of the Canada-United States convention to the facts of whether Norsk's liability to tax in the United States was arising from its domicile, residence, place of management, place of incorporation or any criterion of a similar nature.

The Federal Court of Appeal upheld the decision and found that:

⁵¹¹ Richard G. Tremblay: "Crown Forest - Tax Treaty Interpretation Bonanza", *Canadian Current Tax*, Vol.4(1994), C43.

"Norsk was liable to tax on that part of its income which is effectively connected with the conduct of its United States trade or business but that, in making this finding, various factors were to be considered.

Despite the fact that the place of management criterion was found not to be a factor which would determine the corporation's income to be effectively connected with the conduct of its United States trade or business they stated that the reason that Norsk's income was effectively connected with trade or business which it actively conducted in the United States was because Norsk's place of management was located in the United States where it conducted its trade or business."⁵¹²

The Minister appealed to the Supreme Court with the support of the Government of the United States stating that Norsk conducts a trade or business which is effectively connected with the United States and has income arising from that business which is also effectively connected with the United States. Norsk's existing place of effective management is located in the United States and it is a factor in determining that its business is connected with the United States.

For the Minister, the criterion for residency is in the contracting party and the Convention is different. He stated that the parties in the Convention intended only that persons who were resident in one of the contracting states and liable to tax in one of the contracting states on their world-wide income, not just source income, be considered "residents" for purposes of the Convention. For this reason, he appealed to the Supreme Court that Norsk was not a resident of the United States for the purposes of Article IV of the Canada-United States convention.

After the Minister's appeal the Supreme Court reviewed the case. The Supreme Court first examined whether Norsk was liable to pay tax in the United States. They supported the idea of the expert witness, Ginsburg, who claimed that, "Norsk is liable to tax in the United States because it conducts a "trade or business which is effectively connected with the United States"...This latter expression is not identified in the Internal Revenue Code...but it is determined by subjective factors according to common law...

⁵¹² Supra., footnote-504.

The United States taxes foreign corporations on the basis of the continuous and continuing conduct of an active trade or business within the territorial jurisdiction of the United States and taxes the trade's or business' world-wide income "sourced" either within or outside of the United States... The facts that the foreign corporation's head office and place of management are in the United States are one factor - a principal factor - in determining whether it carries on a trade or business in the United States"⁵¹³.

For Decary J. A. the trial judge made a mistake in determining Norsk's places of management causing its liability to tax in the United States and added, "...the reason for which Norsk is liable to tax in the United States is not because its place of management is located in the United States, but because the trade or business it conducts is effectively connected with the United States, that connection being established, amongst various factors, by Norsk's place of management. The nuance is of major significance: liability to tax derives from Norsk's place of management which, in itself, does not make Norsk liable to tax in the United States"⁵¹⁴.

The Supreme Court exposed the nub of the problem. Although Norsk's place of management was a prime factor in its liability to tax in the United States, this does not mean the United States tax liability operates by reason of its place of management being in the United States.

The Supreme Court held that Norsk conducted trade or business effectively connected to the United States and Norsk's place of management was in the United States. Norsk's United States tax liability is under the "engaged in trade or business" criterion, not the "place of management".

They confirmed the statement which was made by Decary J. A. that: "To say that Norsk, which is not liable to tax by reason of its place of management, is liable to tax by reason of a criterion of a similar nature because of its place of management is one of the factors to be considered in determining the very reason of its liability to tax, i.e. the conduct of a business..., is to beg the question and try to enter through a door that has already been closed..."⁵¹⁵.

⁵¹³ Supra., p.504.

⁵¹⁴ Idem(Supra).

⁵¹⁵ Idem(Supra).

Finally, on 22.6.1995 the Supreme Court found that, limiting Crown Forest's tax by withholding to 10 per cent was an error made by the Trial Division. Therefore, the taxpayer had to pay 25 per cent tax by withholding.

After the decision, some questions still remain. For example, when the Supreme Court reached this decision it did not investigate whether the models and their commentary should be considered to be part of the general rule of interpretation or as a supplementary mean of interpretation⁵¹⁶. The importance of the distinction is whether the commentary should be referred to as part of the context or merely to find or confirm the meaning of the term⁵¹⁷.

However, it is possible to say that the Supreme Court was using the commentary as part of the general rule because of the reference to "legal context"⁵¹⁸. The intervening Government of the United States' submission has been supported in the Supreme Court that⁵¹⁹, "...in ascertaining these goals and intentions, a court may refer to extrinsic materials which form part of the legal context (these include accepted model conventions and official commentaries thereon) without the need first to find an ambiguity before turning to such materials."

Furthermore, for the interpretation of the convention the Supreme Court seems to use both strict and teleological interpretation⁵²⁰ as expressed in the Supreme Court in the following:

"On a direct application of Article IV, I hold that Norsk is not a resident. This conclusion is confirmed when undertaken with an eye to the intentions of the drafters of the Convention and to the goals of international taxation treaties. In other words, I do not believe that Norsk should be considered a resident under Article IV of the Convention nor that the designers of the Convention would have envisioned that it ought to benefit from the preferential tax treatment accorded to residents. Reviewing the intentions of the drafters of a

⁵¹⁶ Ward, et. al., op. cit., p.413.

⁵¹⁷ Ibid., p.414.

⁵¹⁸ Idem.

⁵¹⁹ Supra., footnote-504.

⁵²⁰ Supra., p.53.

taxation convention is a very important element in delineating the scope of the application of that treaty."⁵²¹

However, it is not clear how the Supreme Court found the intention of the drafters since only some written sources are available for the Courts such as convention, commentaries, related articles and the written and oral submissions⁵²². One source for the intention of the parties could be the arguments of counsel of both governments before the court⁵²³.

In *Yamaska Steamship Company Limited v. M.N.R.*⁵²⁴, the corporation was constituted under the laws of Canada and had a ship which was operating between the United Kingdom and West Africa. A British agent was controlling everything in the company. The only activity performed by the Canadian directors was the collection of charter hire payments from the operation of the ship. Furthermore, there were no meetings. Because of these reasons, the Tax Appeal Board decided that the company was not resident in Canada.

In *Sifneos v. M.N.R.*⁵²⁵, Sifneos was a non-resident shareholder of Rex Shipping which was a Canadian corporation. The company was chartering its own ships to third parties. The management of the ships was undertaken by a United Kingdom company, Hadjilias & Co. Ltd. which was controlled by Hadjilias who also controlled Rex Shipping at the same time. Under the management agreement Hadjilias & Co. Ltd. was responsible for chartering, insurance and repairs for the ships.

The directors of Rex Shipping were all Canadian and they were doing all necessary administration for the company such as signing all documents and contracts, passing resolutions, holding meetings etc. However, all the instructions were coming from Hadjilias & Co. Ltd., and its principal. The Court found that Rex Shipping was resident in Canada, because although the directors took instructions from Hadjilias & Co. and its principal they were exercising controlling power and authority in Canada.

⁵²¹ Supra., footnote-504.

⁵²² Ward, et. al., op. cit., pp.415-416.

⁵²³ Ibid., p.416, footnote 21.

⁵²⁴ 61 D.T.C. 716 in Boidman-Ducharme, op cit., p.40.

⁵²⁵ Idem.

In Canada, the only case referring to dual residency was *Crossley Carpets (Canada) Ltd. v. M.N.R.*⁵²⁶. In this case, the company was incorporated in the United Kingdom and all of its business was carried on in Canada. The company was run by a Canadian resident manager and he consulted with one of the British directors who visited Canada almost four months every year. The Tax Appeal Board decided that the company had dual residence.

A "place of business" is important for the existence of permanent establishment. The first requirement in determining the existence of permanent establishment is a "*place of business*". The term "business" is one without a precise meaning and in this context case law is important⁵²⁷. For example, it has been stated in *Halcrow v. MNR.*⁵²⁸, *Canadian Pacific Ltd. v. The Queen*⁵²⁹ and *United Geophysical Co. of Canada v. MNR.*⁵³⁰ that when a non-resident lessor does not carry on a business in Canada, he does not have a permanent establishment.

The Commentary to the OECD Model Convention states that if a business has open land or empty warehousing or any space at its disposal then it has a place of business irrespective of whether the space is rented or owned⁵³¹.

The OECD attitude to the problem can be questioned. The mere existence of some "space" does not seem sufficient for it to be appropriate to consider that the enterprise has a permanent establishment. There must be some indication that the enterprise has a control over that space with at the very least some building, be it a hut, to which letters can be delivered to the company.

An office must be staffed and operational and plant or other facilities must be equipped to carry on business activity defined as in *Fiebert v. MNR.*⁵³². If an employee has decided to use his home as an office and pays his own expenses, the place is not a

⁵²⁶ 69 D.T.C. 5015.

⁵²⁷ *Infra.*, p.152.

⁵²⁸ 80 D.T.C. 1697 in Richard G. Tremblay, "Permanent Establishments in Canada", *The Journal of International Taxation*, January/February-1992, p.307, footnote-26.

⁵²⁹ 76 D.T.C. 6120.

⁵³⁰ (1961), Ex. C. R. 283.

⁵³¹ The OECD Commentaries on Article 5, para.4.

⁵³² 86 D.T.C. 1017.

permanent establishment of the employer as defined in *Sunbeam Corporation (Canada) Ltd. v. MNR*⁵³³.

In Canada, the activities must include a reasonable expectation of profit for the existence of business as expressed in *Moldowan v. The Queen*⁵³⁴. In this case the important question is whether this profits should include foreign portions of the non-resident's business.

Where the non-resident has business within and outside Canada, the test to find the reasonable expectation of profit is applied by the Revenue Canada to the whole business of the enterprise including the non-Canada aspects, although there is an argument, forwarded by Richard G. Tremblay for applying it just to that part of the business carried on in Canada, which seems preferable to the approach taken by Revenue Canada⁵³⁵.

The company must have sufficient business profit in Canada irrespective of its profits outside Canada. It can be argued that it is in Canada's best interest to enquire only into activities within the confines of the country and thereby create a welcoming environment for foreign companies which will provide tax revenues on their activities within the country.

The Supreme Court of Canada requires that there should be somebody to contact for the existence of a permanent establishment but, for the OECD a place of business (and permanent establishment) exists when the enterprise simply has a certain amount of space at its disposal. I believe that the existence of a person to contact with the company would be preferable since it could be an indication that the company is using the permanent establishment.

In *Tara Exploration and Development Co. Ltd. v. M.N.R.*⁵³⁶, the Supreme Court of Canada decided that despite the existence of an office in Canada, there was no person in the office with capacity to make contracts on behalf of the non-resident and therefore, there was no permanent establishment.

⁵³³ 62 D.T.C. 1390.

⁵³⁴ 77 D.T.C. 5213.

⁵³⁵ Tremblay, op. cit., p.308.

⁵³⁶ 70 D.T.C. 6370, 72 D.T.C. 6288 in Tremblay, op. cit, p.308.

In *Enterprise Foundry (NB) Ltd. v. M.N.R.*⁵³⁷, a non-resident company's stock was stored in another corporation's warehouse in Canada. But an employee of the non-resident company was effectively controlling its stock. In this case the court accepted that the non-resident taxpayer had a permanent establishment, because a substantial degree of control was exercised by the taxpayer over the warehouse. Even if there existed only a very small space it was sufficient to consider that it had a permanent establishment.

When a non-resident owns several apartment buildings in Canada it is still possible that he may not have a permanent establishment in Canada⁵³⁸.

The Revenue Canada also stated that if a corporation has a fixed place of business in a province, it has a permanent establishment there⁵³⁹. For example, a place, plant or natural resource used in the day-to-day business of the corporation is a fixed place of business, even huts in a field are deemed to be a fixed place of business. It is not important how long a fixed place of business has been in existence in a province.

The following examples can be given for the existence of fixed place of business⁵⁴⁰. Canada Tax Appeal Board decided in *Les Entreprises Blaton-Aubert Societe Anonyme v. M.N.R.*⁵⁴¹ that a permanent establishment existed during the construction of a pavilion which was the taxpayer's place of business despite the fact that it was in existence for a very short period.

In *Fowler v. M.N.R.*⁵⁴², the Tax Court of Canada stated that the non-resident taxpayer, who sold various household items from a trailer and collapsible boot for three weeks each year, had a permanent establishment. In this case three weeks was considered as a time limit for the existence of permanent establishment which would be considered very short in contrast to the 12 months in the Models.

In Canada, a corporation is deemed to have permanent establishment when it uses substantial machinery or equipment in a particular place in a province. It is not

⁵³⁷ 64 D.T.C. 660 in Tremblay, 308.

⁵³⁸ *Idem*.

⁵³⁹ The Revenue Canada, Interpretation Bulletin, IT-177R2, 4.5.1984, p.1.

⁵⁴⁰ Tremblay, *op. cit.*, p.309.

⁵⁴¹ 69 D.T.C. 121, 73 D.T.C. 5009.

⁵⁴² 90 D.T.C. 1834.

necessary for the company to own the machinery or equipment. Generally, in order to determine whether the machinery and equipment is substantial, one or more criteria are used such as the size, quantity and dollar value of the machinery or equipment⁵⁴³.

An office also could be an indication to have a permanent establishment. In the 1992 technical interpretation, Revenue Canada states that:

"...it is essentially a question of fact, having regard to the definition in the applicable income tax convention or, if there is no applicable convention, Taxation Regulation 400(2), as to whether a corporation has a permanent establishment in respect of its international shipping business, i.e. that some part of the international shipping business, in respect of which the corporation is entitled to exemption from Canadian tax under paragraph 81(1)(c) be carried on in the country in which the corporation is resident, the mere maintenance of a registered office (utilising a local firm of lawyers or accountants) would likely not, in and by itself, constitute a permanent establishment in respect of the corporation's international shipping business."

In the Taxation Regulation 400(2), the permanent establishment includes an "office" of the taxpayer, but it is not clear whether office premises and a single part-time employee are included in this definition⁵⁴⁴.

In *Consolidated Premium Iron Ores Ltd. et. al. v. C.I.R.*⁵⁴⁵, the Canadian Court stated that:

"...the term 'permanent establishment' normally interpreted suggests something more substantial than a licence, a letter-head and isolated activities. It implies the existence of an office, staffed and capable on day-to-day business of the corporation and its use for such purpose, or it suggests the existence of a plant or facilities equipped to carry on the ordinary routine of such business activity. The descriptive word 'permanent' in the characterisation 'permanent establishment' is

⁵⁴³ 34 T.C. 894 (1960), 299 F.2d 623 (1962) in Tremblay, op. cit., p.309.

⁵⁴⁴ Owen, op. cit., p.746.

⁵⁴⁵ 57 DTC 1146.

vital in analysing the treaty provisions. It is the antithesis of temporary or tentative. It indicates permanence and stability."

e- "Income earned from international traffic"

A major question that must be answered is which ancillary activities will be treated as producing transportation income for the purposes of the exemption granted by paragraph 81(1)(c).

*Furness, Withy & Co. Ltd. v. M.N.R.*⁵⁴⁶ is the only Canadian case that deals with the issue of whether services provided to ships are included in the definition of income earned from international traffic. In this case, the Supreme Court of Canada found that income earned from management services provided to competing ship operators and subsidiaries or affiliated shipping companies was taxable. Company income from servicing its own or charter ships was exempted from taxation by the Court.

The following incomes may be considered as an "income earned from the operation of a ship" in the light of *Furness, Withy & Co. Ltd. v. M.N.R.*⁵⁴⁷:

- 1- Profits obtained from the carriage of passengers or cargo;
- 2- Profits obtained by leasing a ship on a time charter or voyage charter basis;
- 3- Income from services provided that are ancillary to the operation of a ship in international traffic.

The last of these categories presents a problem, in that if ancillary activities are incidental for such operations, the income from these activities may be included in the definition of income from the operation of a ship. However, it does not make clear which ancillary activities are incidental to the operation of a ship⁵⁴⁸.

As a basic example, the OECD Commentary lists several ancillary activities in international traffic to which the exemption applies. It states that these activities, all by

⁵⁴⁶ 66 D.T.C. 5358, 68 D.T.C. 5033 in Owen, op. cit., p. 737, footnote-35.

⁵⁴⁷ Owen, p.739.

⁵⁴⁸ Owen, op. cit., p.739.

reason of their nature or their close relationship with profits directly obtained from transport may all be placed in a single category⁵⁴⁹.

These ancillary activities are as follows:

- a- the sale of passage tickets on behalf of other enterprises;
- b- the operation of a bus service connecting a town with its airport;
- c- advertising and commercial propaganda;
- d- transportation of goods by truck connecting a depot with a port or airport⁵⁵⁰.

According to Davies, it is possible to add other activities carried on by airlines, such as maintenance, catering and ground handling, to the list⁵⁵¹.

On the other hand, the OECD Commentary to Article 8 excludes some income from international traffic⁵⁵²:

1- Profits from leasing a ship or aircraft on a bareboat charter basis except when it is an occasional source of income for an enterprise engaged in the international operation of ships or aircraft.

2- The investment income of international transport enterprises. Lease payments are classified as rental payments and do not fall within the scope of the exemption⁵⁵³.

Some other types of income do not qualify for the exemption in paragraph 81(1)(c) of the Canadian Income Tax Act. For instance, the income of enterprises that charter a fully crewed aircraft does not qualify, since this does not constitute "*operation of aircraft*"⁵⁵⁴. Also, income from the sale of aircraft is not within the exemption⁵⁵⁵.

⁵⁴⁹ The OECD Commentary on Article 8, para.4.

⁵⁵⁰ Ibid., para.8.

⁵⁵¹ Davies, op. cit., 142.

⁵⁵² The OECD Commentary on Article 8, paragraphs 1(4) and 1(5).

⁵⁵³ The OECD Commentary on Article 8, paragraphs 1(4) and 1(5).

⁵⁵⁴ Daniel Lang, "Taxation of International Aviation: A Canadian Perspective", *Canadian Tax Journal*, Vol.40(1992), No.4, p.891.

⁵⁵⁵ Lang, p.890.

Some countries do not grant any exemption for foreign enterprises, and thus their enterprises do not qualify for article 81(1)(c) relief which is why the operator must pay tax in both the country of residence and the country of destination. Some countries such as Chile, the Dominican Republic⁵⁵⁶, Fiji, Hong Kong, and Peru, have no tax relief for Canadian Airlines. Airlines resident in these countries are liable to be taxed in Canada on their Canadian source income if they operate there⁵⁵⁷.

Under paragraph 81(1)(c), a time or voyage charter qualifies for the exemption⁵⁵⁸. The income attributed to a bareboat charter rental is not covered by this exemption⁵⁵⁹, but is subject to 25% tax by withholding.

A time charter is a charter by which, the operator supplies the crew for the charterer. The charterer has a freedom to use cargo or passenger capacity on as many trips as he likes within the agreed time.

A voyage charter is similar to a time charter except that a voyage charter is only for one voyage.

A bareboat charter is different to a time or voyage charter. Although the charterer does everything, such as managing the transportation and providing the crew in time or voyage charters, in a bareboat charter the only thing provided by the owner is the vessel⁵⁶⁰.

Another problem area is income from bareboat charters. Revenue Canada's view is that revenue from a bareboat charter does not fall within the scope of the definition of income earned from the operation of ship and aircraft⁵⁶¹, yet for Owen, the exclusion

⁵⁵⁶ A double taxation agreement exist between Canada and the Dominican Republic, signed at Ottawa on 6.8.1976, but it allows the source country to tax the profits from the operation of aircraft in international traffic. Shipping in contrast, is still eligible for a full exemption(Lang, p.893, footnote-49).

⁵⁵⁷ Lang, p.893, footnote-49.

⁵⁵⁸ Hugh B. Lambe, "The Canadian and United States Reciprocal Tax Exemptions, *Canadian Tax Journal*, Vol.40(1992), No.4, p.122.

⁵⁵⁹ The Revenue Canada-Interpretation Bulletin, IT-494, 31.1.1983, Article 3.

⁵⁶⁰ Lambe, op. cit., p.122, footnote-21.

⁵⁶¹ The Revenue Canada- Interpretation Bulletin, IT-494, 31.1.1983, para.3 "Neither the exempting provisions of paragraph 81(1)(c) concerning the operations of a ship or aircraft in international traffic nor

is at odds with the scheme of the Act and regulations. He thinks that, under the combination of paragraph 81(1)(c) of the Income Tax Act and Income Tax Regulation 1102(3)⁵⁶², revenue from bareboat charters could be subject to exemption⁵⁶³.

It is not clear what is the difference between a time or a voyage charter and a bareboat charter from the point of rental income or income earned from the operation of a ship or an aircraft. The only difference is that the owner supplies crew and manager the transportation for a time or voyage charter, and only supplies the vessel for bareboat charter.

In my view, there is no practical need for a distinction to be drawn between income from a time or voyage charter on the one hand, and a bareboat charter on the other.

Another problem area in the context of the term "income from the operation of ship" is whether a gain from the disposition of a ship used in international traffic is in the concept of paragraph 81(1)(c)⁵⁶⁴. The Revenue Canada states that, "paragraph 81(1)(c) of the Act does not apply to capital gains"⁵⁶⁵.

Under 1992 Technical Interpretation, the Canadian Revenue stated that the company engages in the operation of a ship in the following circumstances and they can receive an income from these activities⁵⁶⁶:

- 1- Where it owns the ship, provides the crew and arranges passengers or cargo in the course of their own transportation business.

the provisions of any bilateral shipping and air transport agreements apply to bare boat charter hire because the income is rental income and not 'income earned ... from the operation of a ship or aircraft'."

⁵⁶² It states that where a taxpayer is a non-resident person, the classes of property described in schedule II of the regulations shall be deemed not to include property that is situated outside Canada. This regulation could apply to ships operating solely in international waters since such ships would be situated outside Canada, notwithstanding the charter arrangement was concluded in Canada and payment was received in Canada (Owen, op. cit., p.736, footnote-33).

⁵⁶³ Owen, op. cit., p.736, footnote-33; see, The Revenue Canada-Interpretation Bulletin IT-494, 31.1 1983, at paragraph 3.

⁵⁶⁴ Owen, op. cit., p.742.

⁵⁶⁵ The Revenue Canada-1991 and 1992 Technical Interpretations.

⁵⁶⁶ The Revenue Canada, 1992 Technical Interpretation.

2- Where it charters its ships and crews to another person

3- Where it charters any ship from another person, with its own crew and arranges passenger or cargo in the course of its own transportation business

4- Where it charters any ship with crew from another person for a specified period or number of voyages, for their own transportation business.

When a company has a transportation business, it may be involved in some activities such as arranging voyages, stevedoring, crewing, catering, repair, marketing, raising capital etc. If a single company undertakes all these activities, they fall under the term "operation of ships". If the activities are undertaken separately, they do not fall under this term. For example when a bank lends money to a transportation company or a shipping insurance company this does not fall within the business of operating ships⁵⁶⁷.

Some other activities are also mentioned in the 1992 Technical Interpretation whether they are within the context of the term "operation of ships". Despite its length, it is very helpful for understanding the concept of transportation:

"A company that owns and operates a ship can be regarded as being involved in a number of discrete activities: raising capital and debt financing; overseeing new construction, acquisitions and dispositions; crewing and catering; performing repairs and maintenance; arranging insurance; marketing; negotiating charters; arranging voyages and soliciting passengers or cargo; and stevedoring. All of these activities as constituting the operation of ships when undertaken as part of an integrated business that is carried on in the same corporation for its own account.

In our view, it was not intended that any of these activities would be so viewed when undertaken separately. For example, neither a bank that lends money to acquire ships, a ship builder, a seaman's employment agency, a shipping insurance company, a cruise line travel

⁵⁶⁷ Idem.

agent nor a dock side cargo handling firm is intended to be treated as being in the business of operating ships.

There can, of course, be situations in which a corporation is engaged in more than one business, and it would not be surprising to find a company that, for example, operated its own line of ships while also running a cargo handling operation for other ship owners. If, in fact, that cargo handling operation had developed to a stage where it was beyond any reasonable requirements of the company's own ships, it would seem appropriate to treat it as a separate business and, in the context of the question at hand, to exclude those revenues arising in connection with cargo services provided to the other ship owners.

If, however, the cargo handling facilities were established and used for the company's own ships, with its services being provided to others only on the odd occasion that the company did not require them for its own use, we would not regard the operation as a separate business and would not propose to exclude any of its revenues from the company's operation of ships.

Where assets are risked or employed in the corporation's integrated shipping business the income therefrom would generally be considered to be from the operation of ships. There may be situations where the intended use of a vessel can not be fulfilled due to economic or other events that could not be reasonably foreseen. For example, with respect to the sub-leasing of ships, where a ship is time chartered in for the purpose of being used by the lessee in its integrated shipping business, and due to subsequent events the vessel can not be so used, revenue from sub-time chartering out the vessel on a temporary basis would normally be considered to be from the operation of ships, provided that the vessel would be returned to its intended use as soon as is reasonable in the circumstances.

The sub-leased vessel would still be considered risked or employed in the corporation's integrated shipping business. While, in these circumstances, the sub-leasing revenue would be considered from the operation of ships, in any case where the sub-time chartering

activity constitutes a separate business the revenue therefrom would not be considered to be from the operation of ships.

Where a ship is owned or bareboat chartered in by a corporation and such ship is bareboat chartered out or sub-bareboat chartered out, as the case may be, revenue therefrom will not normally be considered from the operation of ships.

Where, however, the corporation's leasing activities do not constitute a separate business and the ship was originally acquired or bareboat chartered in to be used in its integrated shipping business to transport passengers or goods and, due to subsequent events, the ship can not be so used and is bareboat chartered out or sub-bareboat chartered out on a temporary basis, provided the vessel was to be returned to its intended use as soon as is reasonable in the circumstances, the revenue therefrom would be considered to be from the operation of ships. Again the vessel would still be considered risked or employed in the corporation's integrated shipping business.

Gross revenue from other property not employed or at risk (i.e. not committed) in the corporation's integrated shipping business, for example, interest on term deposits that are not required for use in the business, will not be considered to be gross revenue from the operation of ships.

While the income of corporation may be from the operation of ships, where a corporation's integrated shipping business consists of both the operation of ships that are used primarily in transporting passengers or goods in international traffic, within the meaning of paragraph 250(6)(a) (qualifying operations), and the operation of ships that are not so used (non-qualifying operations), each of the qualifying

and non-qualifying operations will be considered to be a separate business. The qualifying operation must be the principal business of the corporation if the test in paragraph 250(6)(a) is to be satisfied.

Gross revenue of an integrated shipping business from bareboat chartering out or sub-time chartering out a vessel, that is included in the gross revenues from the operation of ships in accordance with the above comments, provided the vessel was acquired to be used in international traffic, will be "qualifying gross revenue" for purposes of paragraph 250(6)(b)."

In *Furness, Withy & Co. Ltd. v. M.N.R.*⁵⁶⁸, the Canadian Supreme Court decided that the income from managing agency and stevedoring services is not income from the operation of ships or aircraft.

Furness Withy was a United Kingdom resident shipping company that had six branch offices in Canada. The question arose as to whether Furness Withy's Canadian branches' income from managing agency and stevedoring fell within the context of the term "income from the operation of ships or aircraft".

One of the main problems was the expression of both subparagraph 10(1)(c) of Canada's Income Tax Act and Article 5 of the 1946 Canada - United Kingdom tax treaty covering the exception of profits from operation of ships and aircraft. Subparagraph 10(1)(c) of the Canada's Income Tax Act stated that "income for the year of a non-resident person earned in Canada from the operation of a ship or aircraft owned or operated by him..." is exempted. On the other hand Article 5 of the Canada-United Kingdom tax treaty stated that "...profits which a resident of one of the territories derives from operating ships or aircraft shall be exempt from tax in the other territory."

⁵⁶⁸ (1968), 68 DTC 5033.

Thurlow J. expressed in the Exchequer Court⁵⁶⁹ that:

"...In the absence of any expression of judicial opinion on these or similar provisions in effect in other countries, I am of opinion that neither the expression operated by him in section 10(1)(c) of the Act nor the expression from operating ships in Article V of the agreement refers to one whose functions with respect to the ship are merely those of a manager or agent or stevedore combined, and that this is the legal position no matter how extensive the authority exercised by him as such manager or agent or the services rendered by him may be."

After this explanation he concluded that⁵⁷⁰:

"1- That neither section 10(1)(c) of the Income Tax Act nor Article V of the Tax Convention exempts earnings of the appellant from managing or agency or stevedoring services which it renders in Canada to other corporations.

2- That appellant is entitled to exemption under these provisions in respect of the portions of the amounts treated as income by the minister, which arose from entries of charges made by the branches for agency and stevedoring services to ships which were owned or chartered by the appellant and were operated in its own service.

3- That appellant is entitled to deduct, in computing its income from business carried on in Canada, that portion of general office administration expenses properly chargeable to its operations in Canada."

⁵⁶⁹ 66 DTC 5364.

⁵⁷⁰ 66 DTC 5358.

The Supreme Court approved the decision⁵⁷¹.

f- "Substantially similar relief"

The Revenue Canada extend the meaning of the term "*substantially similar relief*" to countries that do not impose an income tax. The corporations which are resident in those countries will be exempted from tax in Canada. Otherwise, the term will be related only to corporations resident in countries that impose a tax on international shipping operations but provide relief⁵⁷².

g- "Carrying on business"

The term "*carrying on business*" is defined in section 253 of the Income Tax Act as follows:

"Where, in a taxation year, a non-resident person

a- produced, grew, mined, created, improved, packed, preserved or constructed, in whole or in part, anything in Canada whether or not exported that thing without selling it prior to exportation, or

b- solicited orders or offered anything for sale in Canada through an agent or servant whether the contract or transaction was to be completed inside or outside Canada or partly outside Canada.

he shall be deemed, for the purposes of this Act, to have been carrying on business in Canada in the year."

One factor which is relevant in the determination of where a company carries on business is the place where contracts are made. Principles in relation to carrying on

⁵⁷¹ 68 DTC 5035; After this problem subparagraph 10(1)(c) of the Canada's Income Tax Act was replaced by subparagraph 81(1)(c) and the Article V of the 1946 Canada-United Kingdom treaty was replaced by Article VII of the 1966 Canada - United Kingdom tax treaty. Both of them then had a same expression as follows: "A resident of one of the territories shall be exempt from tax in the other territory on profits from the operation of ships or aircraft in international traffic."

⁵⁷² Owen, op. cit., p.735.

business have been stated, for example, in an English case *Crookston Brothers v. Furtado*⁵⁷³ that "...Viewing the matter in the light of authority, I consider that the following propositions may be deduced from the numerous cases which have been decided. In the first place, if contracts are concluded by or on behalf of a foreigner, and the goods delivered and payment made, all within the United Kingdom, it seems clear that foreigner will be held to exercise a trade in this country. Next, I think the result will be the same if the contracts are concluded and deliveries made in this country, though the payments are received abroad."

The meaning of the term "carrying on business" in this case is broadened to include solicited orders or offered anything for sale in Canada through an agent or servant⁵⁷⁴.

The existence of a permanent establishment in Canada assumes the carrying on of a business there⁵⁷⁵.

The term "*permanent establishment*"⁵⁷⁶ is defined in Regulation 400⁵⁷⁷ which has many criteria to determine if a corporation has a permanent establishment in Canada:

- to have a fixed place of business in a province, which includes a place, plant or natural resource used in the day-to-day business of the corporation.

- to have an employee or agent established in a particular place with a general authority to contract on behalf of the corporation or an employee or agent has a stock of goods owned by the corporation from which the employee or agent regularly fills orders.

- to use substantial machinery or equipment in a particular place in a province.

- to have a rental income which constitutes income from a business.

⁵⁷³ (1910) 5 T.C. 602 in Arthur R.A. Scace - Douglas S. Ewens, *The Income Tax Law of Canada*, Carswell Legal Publications, Canada-1983, pp.13-14.

⁵⁷⁴ Ibid., p.14; Lambe, op. cit., p.121.

⁵⁷⁵ The Revenue Canada-Interpretation Bulletin, IT-177 R 2, 4.5.1984, Article 2.

⁵⁷⁶ Supta., p.103.

⁵⁷⁷ The Revenue Canada-Interpretation Bulletin, IT-177 R 2, 4.5.1984, Article 2.

The Revenue Canada have expressed the view that⁵⁷⁸, a "*fixed place of business*" includes an office, branch, workshop, or warehouse. The term "*the use of substantial machinery or equipment*" in a particular place in Canada also constitutes permanent establishment under Regulation 400.

When a foreign transportation company uses substantial machinery or equipment for loading and unloading and has an office for handling freight it has a permanent establishment, and is thus carrying on business in Canada⁵⁷⁹. The corporation need not own the machinery or equipment that it uses. Also, to determine the meaning of the term "substantial" the size, quantity and dollar value of machinery or equipment are some of the criteria to be considered. However, in terms of *No.506 v. M.N.R.*⁵⁸⁰, a ship is not within the context of the definition of "substantial machinery or equipment" and does not constitute a permanent establishment⁵⁸¹.

In *America Wheelabrator & Equipment Corporation*⁵⁸², the Court found that the company did not have a permanent establishment. In this case, the non-resident company's offices and factories were situated in the United States. Only a sales representative was in Canada without any office.

In practice, many attempts have been made to determine the concept of "to have a trade or business". For example, the following list include some conditions for "carrying on business" in Canada:

"1- If a non-resident maintains a physical establishment in Canada for the purpose of his trade, whether a branch office, a factorship, receivership or agency where contracts are habitually concluded by him or on his behalf: or

2- If a non-resident maintains a stock of goods in trade in which his ownership remains fully vested at such a physical establishment or in a public or other warehouse in Canada and makes sales or satisfies contracts therefrom directly or through his agent. Likewise if the stock

⁵⁷⁸ The Revenue Canada-Interpretation Bulletin, IT-177R2, 4.5.1984, para.1.

⁵⁷⁹ Lambe, op. cit., p.121.

⁵⁸⁰ 58 DTC 258.

⁵⁸¹ Lambe., p.121, footnote-18.

⁵⁸² 51 DTC 285 in Keyes, op. cit., p.48.

of goods is brought to Canada before sale and is kept in Canada in a private or public ware-house and deliveries are made therefrom, a business is being carried on in Canada.

This indication is strengthened if, as above, the goods are the property of the non-resident principal or his resident agent after they have been brought to Canada but before any dealing with them takes place in Canada: or

3- If contracts are habitually made in Canada by a non-resident or on his behalf. The accepted legal tests of where a contract is made have been judicially approved for use in this connection although it has been pointed out that it is not necessary for a contract to be made by a resident agent in the name of his non-resident principal so long as the principal is legally bound by the contracts entered into: or

4- If a non-resident maintains no physical establishment and is not present within Canada during the year, yet the concluded of the contract and the delivery of the goods or such consummation and the payment of the price are effected within Canada: or

5- If delivery of goods in Canada sold by a non-resident under a contract entered into abroad is the main object of a transaction with a Canadian resident and is satisfied in such a manner to constitute carrying on business, then such business is being carried on in Canada: or

6- If the contract of sale is made abroad but the goods which are the object of it are made or transmogrified in Canada by or on behalf of a non-resident. When, however, the contract, delivery and payment together with the goods are made abroad and all that occurs in Canada is the entry into Canada of an agent or technician to instal, erect, advise or supervise on behalf of the non-resident as an incident to and in connection with the foreign transaction, business cannot be considered to be carried on in Canada by reason of such ancillary action alone: or

7- If a non-resident produces, grows, mines, creates, manufactures, fabricates, improves, packs, preserves or constructs, in

whole or in part, anything within Canada exports the same without sale prior to the export thereof, he shall be deemed to be carrying on business in Canada and to earn within Canada a proportionate part of any profit ultimately derived from the sale thereof outside of Canada. The Minister shall have full discretion as to the manner of determining such proportionate part: or

8- (1) If a non-resident solicits orders or offers anything for sale in Canada through an agent or employee, and whether any contract or transaction which may result therefrom is completed within Canada or without Canada, he shall be deemed to be carrying on business in Canada and to earn a proportionate part of the income derived therefrom in Canada.

(2) The Minister shall have full discretion as to the manner of determining such proportionate part.

(3) The Governor in Council shall have power to exempt from the operation of this section the income in whole or in part of residents of any country which enters into reciprocal agreement with Canada to exempt the income of residents of Canada earned in such country”⁵⁸³.

Some activities on the list are quite similar to those in the United States. For example, "to have an office, a factorship, warehouse and an agent". Also, to make sales and contracts, distribution activities and the activities in no.7 on the list are other similarities with the United States.

Some principles can be identified from the decisions of the Canadian Courts in the determination of the term "carrying on business in Canada":

“1- A business is carried on in the country where the essential or profit-producing contracts are habitually entered into; however, while this factor is of substantial importance, it may not be the determining factor if there are other factors present that outweigh its importance.

⁵⁸³ H.H. Stikeman, “‘Carrying on Business in Canada’ in Dominion Income Tax Law, *The Canadian Bar Review*, Vol.20(1942), No.2, pp.104-105.

2- The purchase of property in one jurisdiction for sale elsewhere does not constitute carrying on business in that jurisdiction.

3- The intention to carry on business will be a contributing factor to a positive finding of carrying on business in Canada. Such an intention may be derived from the use of services of persons resident in Canada.

4- Another test adopted by the courts relies on the place from which the profit emanated or in which the profit is generated. To make this determination, courts have looked at circumstances such as the method, duration, and location of any activity or negotiation that led up to the coming into being of the main contract. Other factors considered by the courts in the "profit emanation or generation" test include

- a- intention or purpose of the business;
- b- place of delivery of the materials or goods;
- c- place of payment when combined with other factors such as place of contract, place of delivery, or place of the warehouse;
- d- place where purchases are made, manufactured, or produced;
- e- location of inventory of goods;
- f- place of representative or resident expert;
- g- location of the agent or official in Canada with decision-making authority;
- h- location of any bank account, branch office, phone number, mailing address, or employees in Canada;
- i- the provision of regulatory or tax permits or exemptions that indicate that Revenue Canada is treating the company as doing business in Canada.

5- Ancillary activities done in Canada, such as the servicing or installation of equipment sold to Canadians by a non-resident of Canada, may not always constitute the carrying on of business in Canada.

6- A non-resident will often be considered to be carrying on business in Canada if activities are conducted through an agent. The agent or agents may be the subsidiary of a parent corporation, other partners in a partnership, stock brokers, or a bare trust corporation. Whether a person is an agent of the non-resident or an independent contractor is a far more difficult question”⁵⁸⁴.

The Canada Tax Service also prepared a definition for the term "carrying on business in Canada" as a guideline which includes the following activities:

- 1- If a non-resident maintains a physical establishment in Canada for the purpose of his trade, whether a branch office, a factorship, receivership or agency where contracts are habitually concluded by him or on his behalf;
- 2- If a non-resident maintains a stock of goods in trade in which his ownership remains fully vested at such a physical establishment or in a public or other warehouse in Canada and makes sales or satisfies contracts therefrom directly or through his agent;
- 3- If his contracts are habitually made in Canada by a non-resident or on his behalf;
- 4- If a non-resident maintains no physical establishment and is not present within Canada during the year, yet the conclusion of the contract and the delivery of the goods or such conclusion and payment of the price are effected within Canada;
- 5- If a non-resident person solicited orders or offered anything for sale in Canada through an agent or servant...;
- 6- If the contract or sale is made abroad but the goods which are the object of it are made or transformed in Canada by or on behalf of a non-resident...;

⁵⁸⁴ Kroft, op. cit., pp.1:47-1:49.

7- If a non-resident disposes of Canadian resource property, a timber resource property (or an interest in or option in respect thereof) or real property, other than capital property, situated in Canada (including an interest therein or option in respect thereof)⁵⁸⁵.

When a non-resident company has an agent, will be regarded as having a trade or business in the country. Sometimes the question arise as to whether a distributor acting for non-resident is in fact an agent. Several points are relevant such as:

- 1- Whether the goods are sold in the name of the distributor or in the name of the non-resident.
- 2- Whether the distributor maintains an inventory of goods or whether he places an order with the non-resident only after he himself receives an order.
- 3- Whether the distributor is entitled to accept orders without authority from the non-resident.
- 4- Whether the distributor is free to fix the price at which the goods are sold by him.
- 5- Whether the prices are paid by the customers to the distributor or directly to the non-resident.
- 6- If the price is paid to the distributor, whether the distributor holds the price in trust and keeps it in a separate account until it is remitted to the non-residents, subject to the deduction of the distributor's commission.
- 7- Whether the price paid by the distributor to the non-resident varies according to the price at which the distributor sells the goods, --i.e., whether the distributor in effect receives a commission based on the ultimate sale price.

⁵⁸⁵ Kroft, p.1:50.

- 8- Whether upon delivery of the goods to the distributor the legal title passes to him and whether after such delivery he bears the risk of loss or destruction of the goods.
- 9- Whether the distributor is liable to retain the goods and to pay the non-resident for them regardless of whether or not he seels them⁵⁸⁶.

In *Pickford v. Quirke*⁵⁸⁷, Lord Hanworth offers to examine the transactions that are repeated:

"...you may have an isolated transaction so independent and separate that it does not give you any indication of carrying on trade...includes every trade, manufacture, adventure or "concern in the nature of trade". When however, you have to look at four successive transactions you may hold that what was considered separately and apart a transactions to which the words 'trade or concern in the nature of trade' could not be applied, yet when you have that transaction repeated, not once nor twice but three times, at least, you may draw a completely different inference from those incidents taken together."

For Sargant L.J. even a single bulk purchase may constitute a trade. However, there must be series of retail sales after the purchase. A series of retail purchases followed by one bulk sale may constitute a trade as expressed in *Martin v. Lowry*⁵⁸⁸. Also, Lord Esher M.R. mentioned the necessity of several series transactions for carrying on business in *In re Griffin*⁵⁸⁹.

The activities of a company and other related facts and circumstances of business may indicate the carrying of business as Dr. Manfred Curry stated in *Income Tax*

⁵⁸⁶ Kroft, p.1:50.

⁵⁸⁷ (1927), 13 T.C. 269 in Stikeman, op. cit., p.80.

⁵⁸⁸ (1926), 11 T.C. 297.

⁵⁸⁹ 60 L.J.Q.B. 237 in Stikeman, op. cit., p.80.

*Case No.379*⁵⁹⁰. The bare memorandum of association by itself is not sufficient to determine that company is carrying on business.

However, in *In re Alabama Railway Co.*, it has been stated that, to form a company for business indicates continuity and for this reason, it is sufficient that the company is carrying on business⁵⁹¹.

The company's annual sales, advertisement policy and deliveries may indicate the existence of carrying on business. For example, in *In re Income Tax Act 1932 v. Proctor and Gamble Co.*⁵⁹², Taylor J. found that the company was carrying on business:

"It seems somewhat a refinement of reasoning to suggest that this company is not doing business within the province. The fact is that they find a market here for their products and advertize in that market extensively by radio announcement, magazines and other methods. Their salesman 'push' sales here and take orders or offers to purchase from Saskatchewan purchasers. These orders happened to have on them a printed clause that they are not binding on the company until they are accepted at head office but the practice is to ship these orders without special acceptance in any case. They thus sell and deliver into Saskatchewan annually about \$300,000 of their products. That seems to be doing a pretty good business in Saskatchewan."

Furthermore, another requirement for carrying on a business is that activities be undertaken with a reasonable expectation of profit as expressed in *Moldowan v. The Queen*⁵⁹³. In *Ransom v. Higgs*⁵⁹⁴, Lord Wilberforce stated that, there must be a reward to provide the business. However, it has been expressed in *C.I.R. v. Incorporated Council of Law Reporting*⁵⁹⁵ that "carrying on a trade" means not necessarily to make profit.

⁵⁹⁰ (1937), 9 SATC 339 in *ibid.*, pp.81-82.

⁵⁹¹ (1872), 1 Federal Cases 217 in *Stikeman*, 81-82.

⁵⁹² (1938), 2 D.L.R. 597 in *ibid.*, pp.97-98.

⁵⁹³ (1977), 77 D.T.C. 5213, (1975), 75 D.T.C. 5216 in *Trembley*, *op. cit.*, footnote-28.

⁵⁹⁴ (1974), 50 T.C. 88.

⁵⁹⁵ (1888), 3 T.C. 105.

h- Other terms

The terms "*principal business*"⁵⁹⁶, "*principal purpose*"⁵⁹⁷ and the word "*primarily*"⁵⁹⁸ are not defined in the Income Tax Act despite the fact that they are used in subsection 248(1) which defines "international transportation" and 250(6) relating to the residence of international shipping companies. The terms are interpreted by the Revenue Canada.

The term "*primary*" or "*principal*" refers to "more than 50 per cent"⁵⁹⁹. The term "*principal purpose*" means "the main or chief objective for which the business is carried on."⁶⁰⁰ The term "*primarily*" means 'principally' or 'chiefly'⁶⁰¹.

The term "*gross revenue*" is defined in subsection 248(1) to mean:

"the aggregate of

(a) all amounts received in the year or receivable in the year (depending on the method regularly followed by the taxpayer in computing his income) otherwise than as or on account of capital, and

(b) all amounts (other than amounts referred to in paragraph (a)) included in computing the taxpayer's income from a business or property for the year by virtue of paragraph 12(1)(o) or subsection 12(3),(4) or (8) or section 12.2."

"*The Gross Revenue Test*" is a problematic area in which Revenue Canada has repeatedly interpreted⁶⁰² the phrase "all or substantially all" to mean 90 percent or

⁵⁹⁶ ITA, Subsection 250(6).

⁵⁹⁷ ITA, Subsection 248(1).

⁵⁹⁸ ITA, Subsection 250(6).

⁵⁹⁹ The Revenue Canada-Interpretation Bulletin, IT-486 R, 31.12.1987, article.5.

⁶⁰⁰ The Revenue Canada-Interpretation Bulletin, IT-73 R 4, 13.2.1989, article.11.

⁶⁰¹ See, Angelo Nikolakakis: "Shipping Incentives - Canada Scuttles Precedents", *International Tax Review*, October-1991, p.22.

⁶⁰² "The Revenue Canada Round Table" in *Report of Proceedings of the Forty-First Tax Conference, 1989 Conference Report*, Toronto, Canadian Tax Foundation, 1990 at 45: 8-9 (Question 13). The Revenue Canada-Interpretation Bulletin, IT-483, 13.4 1982, para.3; Technical Interpretation, 23.6.1992, The Reorganizations and Foreign Division of the Rulings Directorate, and discussed in *Window on Canadian Tax*, Don Mills, Ontario, CCH Canadian, para.1970.

more⁶⁰³. It is not clear that the Courts would in all cases uphold the 90% test. If the corporation has sufficient non-shipping income such as investment income, it will be excluded under the test⁶⁰⁴. The only case about this problem is *D. Wood v. M.N.R.*⁶⁰⁵, the Judge stated that "... Clearly the term 'substantially all' does not lend itself to a simple mathematical formula. Further, it would seem to me that any particular definition of 'substantially' would only be valid by reference to the specific context in which it is found."

5- The Foreign Affiliate

Like other countries Canada too wishes to enhance its tax revenues. As well as increasing taxes, stopping abuses of the tax system is another way to increase revenues⁶⁰⁶. In this context the foreign affiliates rule becomes important under the 1992 Report of the Auditor General of Canada⁶⁰⁷.

The Report mentions that tax arrangements for foreign affiliates is costing Canada hundreds of millions of dollars in lost tax revenues. Furthermore, the Minister of Finance announced measures to prevent Canadian-based companies from using foreign affiliates to avoid paying Canadian taxes⁶⁰⁸.

The main purpose of the Canadian foreign affiliate system is to balance competing fiscal policy considerations of Canadian multinationals such as neutrality, competitiveness and the integrity of the revenue base⁶⁰⁹.

The "foreign affiliate" is a non-resident corporation in which a Canadian taxpayer's equity percentage is not less than 10%⁶¹⁰.

⁶⁰³ Owen, op. cit., p.731.

⁶⁰⁴ Ibid., p.732.

⁶⁰⁵ (1987) 1 CTC 2391 in Owen, op. cit., p.731, footnote-19.

⁶⁰⁶ Ingrid Sapona: "Taxation of Foreign Affiliates", *Bulletin for International Fiscal Documentation*, August/September 1994, p.430.

⁶⁰⁷ The Auditor General's Report, *Tax Notes International*, Vol.5 (21.12.1992), p.1425.

⁶⁰⁸ Sapona, op. cit., p.430.

⁶⁰⁹ Elinore Richardson - Angelo Nikolakakis: "Foreign Affiliates Restricted", *International Tax Review*, May-1994, p.43.

The definition of the term "foreign affiliate" is, after 1994 amendments⁶¹¹, as follows:

"Foreign affiliate", at any time, of a taxpayer resident in Canada means a non-resident corporation in which, at that time,

(a) the taxpayer's equity percentage is not less than 1%, and

*(b) the total of the equity percentages in the corporation of the taxpayer and of each person related to the taxpayer (where each such equity percentage is determined as if the determinations under paragraph (b) of the definition "equity percentage" in subsection (4) were made without reference to the taxpayer or in any person related to the taxpayer) is not less than 10%, except that a corporation is not a foreign affiliate of a non-resident-owned investment corporation."*⁶¹²

"Equity percentage" is defined to mean effectively the ownership, directly or indirectly, of 10 percent of the shares of any class of the non-resident corporation⁶¹³.

The foreign affiliate rules are also set out in part LIX of the Income Tax Regulations. Regulation 5906(1) states that a foreign affiliate is deemed to carry on the business:

"(a) in a country other than Canada only to the extent that such business is carried on through a permanent establishment situated therein; and

(b) in Canada only to the extent that its income therefrom is subject to tax under Part I of the Income Tax Act."

⁶¹⁰ ITA, Paragraph 95(1)(d) and Subsection 95(4); See, K.J. Dancey - R.A. Friesen - D.Y. Timbrell: *Canadian Taxation of Foreign Affiliates*, CCH Canadian Limited, Ontario - 1982, p.3.

⁶¹¹ David M. Sherman (Editor), *The Practitioners Income Tax Act*, Carswell-Thompson Professional Publications, Ontario-1996, p.516; Brian Arnold - F. Brent Perry: "An Analysis of the 1994 Amendments to Canada's FAPI and Foreign Affiliate Rules", *Tax Notes International*, 3.10.1994, p.1080.

⁶¹² Income Tax Act, Subsection 95(1).

⁶¹³ ITA, Paragraph 95(1)(d).

The only income that the text mentions is the income subject to tax under Part-1 of the Income Tax Act. However, international shipping companies' transportation income is not subject to tax under Part-1, because it has already been exempted by paragraph 81(1)(c). Therefore Regulation 5906(1)(b) cannot apply for international shipping companies' income.

Some incomes have not been exempted by paragraph 81(1)(c), therefore, they are within the context of Regulation 5906(1)(b). Those are rental income from bareboat charters, capital gains from the disposition of ships and some other incomes that do not fall within the definition of the operation of the ship⁶¹⁴.

Also Regulation 5906(1)(a) applies to the extent of the business activities that are carried through a permanent establishment of the international shipping companies situated outside Canada. These activities are quite insignificant when compared with the activities carried on in Canada, in international waters and in ports of call for the ships⁶¹⁵.

The foreign affiliate incomes are divided into three categories:

- Income from an active business.
- Income from a business other than an active business.
- Income from property.

If income arises from active business⁶¹⁶ in a listed country⁶¹⁷ it will be exempted from Canadian Tax by treaty. The income of a foreign affiliate resident or carrying on activities in a non-listed country, will be subject to Canadian Income Tax.

⁶¹⁴ Owen, p.744, footnote-45.

⁶¹⁵ Idem.

⁶¹⁶ For details see, Jinyan Li: "The Meaning of 'Active Business' for Canadian FAPI Purposes: Canada Trustco Mortgage Company v. M.N.R.", *Tax Notes International*, 1.6.1992, pp. 1130-1134.

⁶¹⁷ The Income Tax Regulation, CRC, C.945, Prentice Hall, Vol.8, 14.10.1982, 5907(11).

However, the absence of a definition of the term "active business income" was problematic as the Public Accounts Committee of House of Commons mentioned in its report on 23.4.1993⁶¹⁸. The Auditor General and the Public Affairs Committee⁶¹⁹ recommended that the Department of Finance clarify the term "active business income".

The case law had suggested that the term "active business" had the same meaning for purposes of the small business deduction⁶²⁰ and the first case to make this suggestion was *Canada Trustco Mortgage Company v. M.N.R.*⁶²¹.

After speculations about active business and explanation of the necessity for the definition of the term, Canada's Federal Budget was announced on 22.2.1994, and it contained draft legislation about tax treatment of foreign affiliates⁶²². On 23.6.1994 Revised Draft Amendments were released⁶²³ which included a new definition of "active business". On 23.1.1995, a revised draft legislation and technical notes dealing with the amendments of foreign affiliate rules was released by the Department of Finance⁶²⁴. On 16.2.1995, the Department of Finance announced Final Foreign Affiliate Amendment Bill C-70⁶²⁵ which follows the 23.6.1994 revisions with some other changes⁶²⁶ and also includes the 23.1.1995 draft legislation.

⁶¹⁸ Brian J. Arnold: "Canadian Legislative Committee Issues Recommendations on Taxation of Foreign Affiliates", *Tax Notes International*, 7.6.1993, p.1359; Li, op.cit., p.1131.

⁶¹⁹ The Public Accounts Committee's Report, *Tax Notes International*, Vol.6 (7.6.1993), p.1359.

⁶²⁰ ITA, Subsection 125(7).

⁶²¹ 91 D.T.C. 1312.

⁶²² Canada, Department of Finance, Budget Papers, Tax Measures: Supplementary Information, Draft Legislation and Explanatory Notes, 22.2.1994.

⁶²³ Canada, Department of Finance, Revised Draft Amendments to the Income Tax Act and Regulations, 23.6.1994.

⁶²⁴ Canada, Department of Finance, Revised Draft Amendments to the Income Tax Act Foreign Affiliates, 23.1.1995.

⁶²⁵ The Bill C-70, An Act To Amend The Income Tax Act, The Income Tax Application Rules And Related Acts.

The term "income from active business" is defined in Income Tax Act Subsection 95(1) as follows:

"Income from an active business' of a foreign affiliate of a taxpayer for a taxation year includes, for greater certainty, any income of the affiliate for the year that pertains to or is incidental to that business⁶²⁷ but does not include

(a) other income that is its income from property for the year, or

(b) its income for the year from a business that is deemed by subsection (2) to be a business other than an active business carried on by the affiliate."

"Business"⁶²⁸ used to include an adventure in the nature of trade, except for certain purposes. Under the draft amendments it is excluded from the definition of "business". Therefore income from an adventure or concern in the nature of trade is not an active business income but is an income from property⁶²⁹.

If a foreign affiliate is resident in one of the designated treaty country, it will qualify for the exemption. A designated treaty country, is a country that has entered into a comprehensive double taxation agreement with Canada. The reason for this change is to eliminate the concept of "listed country"⁶³⁰.

The definition of income from an active business has minor changes in the 1995 amendments. The exhaustive definition using the word "means" has been changed into

⁶²⁶ Nathan Boidman: "Final Foreign Affiliate Amendments: Bill C-70", *Tax Management International Journal*, Vol.24, No.4, 14.4.1995, pp.191-204; Larry F. Chapman: "Foreign Affiliate Amendments: Three Strikes and You're Done", *Canadian Tax Journal*, Vol.43(1995), No.2, pp.433-446.

⁶²⁷ See, *Atlas Industries Ltd. v. MNR.*, 86 D.T.C. 1756.

⁶²⁸ ITA, Subsection 248(1).

⁶²⁹ Arnold-Perry, op. cit., p.1069; Robert J. Dart - David G. Broadhurst: "Foreign Affiliates: Proposed Amendments", *Canadian Tax Journal*, Vol.42(1994), No.4, p.1118.

⁶³⁰ Dart-Broadhurst, op. cit., p.1126.

an expansive definition that use the word "includes" without changing the intent of the definition⁶³¹.

6- Other Related Issues for International Transportation Companies

a- Branch or Additional Tax

A non-resident corporation carrying on business in Canada will also be subject to branch tax at the rate of 25% of the profits⁶³². This rate can be reduced under a tax treaty. For example, under the Canada - United States income tax treaty, the rate is reduced to 10% for United States corporations. Also the first \$500,000 of profits of the United States corporation is exempted by the treaty.

Some deductions are available for non-resident corporation's profits, before being subjected to 25% branch tax. For example:

- a- Canadian taxes,
- b- Specified federal and provincial interest and penalty payments,
- c- An allowance with respect to investment in qualifying Canadian property⁶³³.

A Canadian subsidiary will not be subject to the branch tax, because it is a Canadian corporation.

However, under subparagraph 219(2)(b)(i) of the Income Tax Act, no additional tax is payable by a corporation whose principal business was the transportation of persons or goods.

b- Large Corporation Tax

Large corporation tax applies to certain non-resident corporations at the rate of 0.2% of the amount by which the corporation's taxable capital employed in Canada for the year exceeds its capital deduction for the year⁶³⁴. The term "taxable capital employed in Canada" is defined in section 181.4.

⁶³¹ Sandra E. Jack: "The Foreign Affiliate Rules: The 1995 Amendments", *Canadian Tax Journal*, Vol.43(1995), No.2, pp.355-356.

⁶³² ITA, Section 219 and Income Tax Act Regulation 808.

⁶³³ Andrew H. Kingissepp: "Structuring a New Canadian Business: Branch vs. Subsidiary", *The Journal of International Taxation*, October-1995, p.436.

⁶³⁴ Owen, op. cit., p.752.

Under subsection 181.4(d) of the Income Tax Act, the deduction exemption applies only to a ship or aircraft operated by an international transportation company in international traffic. Also, when the country in which the international transportation companies are resident imposes a tax the exemption from the capital tax base may be eliminated. The deduction does not apply to a charter party arrangements, and the reason is not provided⁶³⁵.

c- Tax by withholding

Tax by withholding⁶³⁶ is imposed on certain amounts paid or credited to a non-resident corporation by a resident of Canada under Part XIII of the Income Tax of Canada. However, if international transportation company is carrying on business through its permanent establishment in Canada, it is not subject to tax by withholding under Part XIII of the Income Tax Act of Canada⁶³⁷. The rate of tax by withholding is now 25 per cent, formerly 15 per cent⁶³⁸.

d- Goods and Services Tax

"Goods and Services Tax"⁶³⁹ is imposed by Canada on domestic flights and flights to the United States (except Hawaii), and to St. Pierre and Miquelon⁶⁴⁰. Other types of international passenger transportation are subject to zero-rate tax⁶⁴¹.

⁶³⁵ Owen, op. cit., pp. 753-754.

⁶³⁶ Although some authors (e. g. Owen, op. cit., p.754 and Lambe, op. cit., p.120) and regulations use the term "*withholding tax*", in my view it is not a kind of tax, it is only a system to collect tax. That is why I prefer to use "*tax by withholding*" rather than " *withholding tax*". For details see, Hakan Uzelturk, *Gelir ve Kurumlar Vergisinde Stopaj* (Income Tax and Corporation Tax by Withholding), LL.M. Thesis (Unpublished), Istanbul-1988.

⁶³⁷ Owen, op. cit., p.754.

⁶³⁸ Summary of 1971 Tax Reform Legislation, pp.90-91.

⁶³⁹ See for details, Abe I. Greenbaum: "The Canadian Goods and Services Tax: An Overview", *Bulletin for International Fiscal Documentation*, June-1991, pp.276-285; Ingrid Sapon: "Goods and Services Tax", *Bulletin for International Fiscal Documentation*, October-1990, pp.489-498; Alan Schenk, *Goods and Services Tax: The Canadian Approach to Value-Added Tax*, CCH Canadian Ltd., Ontario-1993, pp.238-241; Richard M. Bird - David B. Perry - Thomas A. Wilson: "Tax System of Canada", *Tax Notes International*, 9.1.1995, pp.169-178.

Since the United States impose 10 per cent excise tax on all flights that begin and end in the United States or at a Canadian or Mexican destination within 225 miles of the border⁶⁴², Canada seek to maintain the competitive position of Canadian Airlines⁶⁴³ so they imposed goods and services tax on, for example, flights to the United States. Otherwise, the United States Airlines would be in an advantageous position because the tax imposed by the United States on Canadian Airlines flights will be reflected in the ticket price of Canadian Airlines leading to higher prices.

On 23.4.1996, the federal government announced its intention to harmonize the federal goods and services tax with provincial sales tax system which will be implemented by 1.4.1997⁶⁴⁴. The new rate will be 15% and will apply to the same base as the goods and services tax which was previously 7%.

e- Departure Tax

When a resident corporation emigrates to another country, it may become non-resident. But if the corporation's central management and control is still in Canada, it is a resident for the purpose of the Canadian Tax System. After the corporation moves its central management and control, it loses the status of Canadian residence and departure tax will apply⁶⁴⁵.

The departure tax is 25% of the excess of the fair market value of the corporation's property over its paid up capital and indebtedness⁶⁴⁶.

⁶⁴⁰ The Excise Tax Act, RSC 1985, C.E-15, as amended, schedule VI, part VII in Lang, op. cit., footnote-71.

⁶⁴¹ Lang, op. cit., p.899.

⁶⁴² The United States, IRC, Sections 4261, 4262 and 9502.

⁶⁴³ The Goods & Services Tax - Notice of Ways and Means Motion, Special Report No.263, Canadian Goods & Services Tax Report No.4, 19.12.1989, CCH Canadian Limited - Ontario, Section-5: Transportation and Travel, pp.57-62.

⁶⁴⁴ The Revenue Canada, F 9604-I Fact Sheet, GST Changes for Non-Resident Businesses, <http://www.revcn.ca/E/pub/d/f9604iet/f9604ie.txt.html>; For details see, Canada: "Goods and Services Tax - Harmonization and Technical Amendments", *VAT Monitor*, Vol.7(July/August-1996), No.4, pp.185-191.

⁶⁴⁵ Robert Couzin: "Departure Tax - Companies", *Bulletin for International Fiscal Documentation*, April-1996, p.137.

⁶⁴⁶ ITA, Sections 88(1) and 219(1).

CHAPTER VI: TURKEY

1- Introduction

In the Turkish corporation tax system there are two types of liability: full tax liability and limited tax liability. Under full tax liability taxpayers are subject to tax on their world-wide income. Under limited tax liability taxpayers are subject to tax only on specific Turkish source income.

The criteria which determine the liability to be applied are the location of the place of incorporation and the place of effective management. If either the taxpayer's place of incorporation or place of effective management is in Turkey, he is subject to full tax liability on his worldwide income⁶⁴⁷. If neither the place of incorporation nor the place of effective management are in Turkey, limited tax liability⁶⁴⁸ applies and the taxpayer is subject to tax only on specific Turkish-source income. Taxation of Turkish transportation companies are subject to general company rules of the Turkish Corporation Tax Act 1949.

2- Turkish Double Taxation Treaties

From the beginning of the OECD's concern with taxation Turkey has joined all the committees and working groups on the prevention of double taxation in OECD and United Nations. However until 1970, Turkey had not signed any comprehensive double taxation agreement.

The only agreements in the field of taxation that existed before then were with Great Britain in 1930 and with the United States in 1954⁶⁴⁹ in a limited scope. As Turkey did not wish to use the OECD Model, it prepared the Turkish Model for Prevention of

⁶⁴⁷ The Corporation Tax Act (Hereinafter referred to as CTA), Article-9.

⁶⁴⁸ CTA, Article-11.

⁶⁴⁹ Adnan Tezel, *Uluslararası Çifte Vergilendirmeyi Önleme Anlaşmaları ve Türkiye Uygulaması*, TUSIAD, İstanbul, 1989, p.19.

Double Taxation on Income and Wealth Taxes in 1969, even though Turkey was, at that time, a member of the OECD.

The use of the OECD Model was originally thought not to be appropriate at that stage in the history of Turkey's economic progress. Turkey was a developing country and the Model was based on situations relevant to developed countries. Turkey wanted to use the "source principle" instead of the "residence principle" as it was thought that the adoption of the residence principle could affect Turkish tax revenue with a loss of tax income. For this reason, Turkey considered the unilateral methods used in the Turkish tax system to be appropriate for the prevention of international double taxation.

However, some authors expressed the view that in the long term the "residence principle" would not affect Turkish tax revenue in terms of increasing foreign investment and economic developments. In practice, Turkey never used its own Model and it is no longer in existence⁶⁵⁰.

In 1970's, because of a change in economic policy, Turkey began to sign double taxation treaties⁶⁵¹ based on the OECD Model. The first double taxation agreement signed by Turkey was with Austria in 1970 and second was with Norway in 1971. Thereafter, until 1983 Turkey did not sign any further agreement because of a lack of political and economic stability.

Between 1983 and 1996 Turkey signed 34 treaties⁶⁵². The double taxation agreement with Saudi Arabia, signed in 1989, is a limited agreement concerning only air transportation⁶⁵³. At the end of 1996 Turkey was negotiating new agreements with 13 countries⁶⁵⁴.

⁶⁵⁰ For details of Turkish Policy see: Billur Yalti-Soydan, *Uluslararası Vergi Anlaşmaları*, Beta, İstanbul-1995, pp.48-49.

⁶⁵¹ Yalti-Soydan, op. cit., pp.57-58; S. Tuncer, *Çifte Vergileme ve Milletlerarası Vergi Anlaşmaları*, Ankara, 1974, pp.172-174.

⁶⁵² *Infra*, pp.173-175.

⁶⁵³ A kind of agreement which includes only some types of income. It is the opposite of comprehensive agreement.

⁶⁵⁴ Canada, Greece, Indonesia, Iran, Israel, Kazakhstan, Kuwait, Mongolia, Singapore, South Africa, Spain, Switzerland, Thailand, Turkmenistan, Ukraine and United States.

Although the residence principle is mainly followed in Turkish double taxation agreements, the effective management principle and the source principle have also been used for taxation of income from international transportation in double taxation agreements with, respectively, Tunisia⁶⁵⁵ and Northern Cyprus⁶⁵⁶.

In the treaty with Austria⁶⁵⁷, the State of residence has the right to tax the profits from international sea and air transportation. The treaty with Denmark⁶⁵⁸, Finland⁶⁵⁹, Norway⁶⁶⁰ and Sweden⁶⁶¹ also employs the residence principle for international air⁶⁶² and land transportation; for sea transportation, the source principle is used. However, for income from sea transportation, a 50% exemption exists in the source country in the treaty with Norway⁶⁶³. The residence principle is also used in some other Turkish double taxation agreements⁶⁶⁴.

Turkey has made some observations on the OECD Commentary on Article 8 as follows:

1- While agreeing in principle to abide by the provisions of Article 8 in bilateral conventions, Turkey intends in exceptional cases to apply the permanent establishment rule in taxing international transport profits⁶⁶⁵.

⁶⁵⁵ RG: 30.9.1987 / 19590.

⁶⁵⁶ RG: 26.12.1988 / 20031.

⁶⁵⁷ RG: 1.8.1973/ 14612.

⁶⁵⁸ RG: 23.5.1993 / 21589.

⁶⁵⁹ RG: 30.11.1988 / 20005.

⁶⁶⁰ RG: 21.12.1975 / 15445.

⁶⁶¹ RG: 30.9.1990 / 20651.

⁶⁶² For Denmark, Norway and Sweden income from air transportation is subject to tax on their portion of the Scandinavian Airlines System (SAS).

⁶⁶³ RG: 21.8.1975/ 15445.

⁶⁶⁴ Belgium-RG: 15.9.1991/ 20992, France-RG: 10.4.1989/20135, Germany, Hungary-RG: 25.12.1990 / 22152, Italy-RG: 9.9.1983 / 21693, Japan-RG: 13.11.1994 / 22110, Jordan, Kazakhstan-RG: 8.11.1996 / 22811, South Korea , Macedonia-RG: 7.10.1996 / 22780, Mongolia-RG: 30.12.1996 / 22863, Pakistan, Romania, the Netherlands, United Arab Emirates, the United Kingdom and the United States-28.3.1996, (Not yet in force).

⁶⁶⁵ The OECD Commentary on Article 8, para. 26.

The reason for this observation may be that some companies have their permanent establishment in Turkey although their place of effective management is in a different country and Turkey wants to tax those international transportation companies which operate their ships or aircraft from bases in Turkey. Since Turkey's shipping fleet is not well developed Turkey wants to protect this sector. However, there is no explanation of the definition of the term "exceptional cases".

2- Turkey reserves the right, in the course of negotiations for concluding conventions with other Member Countries, to propose that the part of inland transport carried out by means other than that employed for international transport be excluded from the scope of the Article, whether or not the means of transport belong to the transporting enterprise⁶⁶⁶.

In other words, Turkey wants to tax the income by international transportation companies derived from the use of inland waterways which are solely within Turkish territory.

3- Turkey also reserves the right, ..., in the course of such negotiations⁶⁶⁷, to propose that the leasing of containers, even if supplementary or incidental, be regarded as an activity separate from international shipping or aircraft operations, and consequently be excluded from the scope of the Article⁶⁶⁸.

Turkish agreements do not contain any articles about inland waterways, although they contain provisions for sea, air and land transportation. Turkey reserves the right not to extend the scope of the Article to cover inland transportation in bilateral treaties⁶⁶⁹.

⁶⁶⁶ Ibid., para. 27; In this context also Portugal has made the same observation. Spain withdrew its observations on paragraphs 27 and 28 with 1992 amendments.

⁶⁶⁷ The OECD Commentary on Article 8, para.27.

⁶⁶⁸ Ibid., para. 28.

⁶⁶⁹ Ibid., para. 31.

In the agreements with Turkey-Austria⁶⁷⁰ and Turkey-Norway⁶⁷¹ the term "*international traffic*" is not defined. However, some other countries have omitted to provide a definition of international traffic in their double taxation agreements as well. For example, Germany has at least 40 double taxation agreements without the definition of the term "*international traffic*"⁶⁷². The Turkish double taxation agreements with Germany⁶⁷³, Jordan⁶⁷⁴, Romania⁶⁷⁵ and Pakistan⁶⁷⁶ contain a definition of international traffic.

Some Turkish double taxation treaties concern only sea and air transportation⁶⁷⁷. Some others cover not only sea and air transportation but also include land transportation⁶⁷⁸. Turkish double taxation treaties with Hungary⁶⁷⁹ and Macedonia⁶⁸⁰ concern only air and land transportation.

If an aircraft were to leave Ankara for Istanbul then proceed to London and terminate its journey in Manchester, then the Ankara-Istanbul and London-Manchester parts of the journey are considered to be international as well as the Istanbul-London

⁶⁷⁰ RG: 1.8.1973 / 14612.

⁶⁷¹ RG: 21.8.1975 / 15445.

⁶⁷² For the list of the agreements see, Vogel, op. cit., p.128.

⁶⁷³ RG: 9.7.1989 / 19159.

⁶⁷⁴ RG: 15.7.1986 / 19165.

⁶⁷⁵ RG: 21.8.1988 / 19906 and see RG:12.2.1989.

⁶⁷⁶ RG: 26.8.1988 / 19911.

⁶⁷⁷ With Algeria-RG: 30.12.1996 / 22863, Austria, Egypt-RG: 30.12.1996 / 22863, India-RG: 30.12.1996 / 22863, Japan-RG: 13.11.1994 / 22110, Malesia-RG: 30.12.1996 / 22863, Pakistan, South Korea-RG: 2.10.1985 / 18886 and Tunisia.

⁶⁷⁸ With Albania-RG: 5.10.1996 / 22778, Belgium-RG: 15.9.1991 / 20992, China-RG: 30.12.1996 / 22863, Denmark-RG: 23.5.1993 / 21589, Finland-RG: 30.11.1988 / 20005, France-RG: 10.4.1989 / 20135, Germany, Italy-RG: 9.9.1993 / 21589, Jordan, Kazakhstan-RG: 8.11.1996 / 22811, Mongolia-RG: 30.12.1996 / 22863, Northern Cyprus, Norway, Poland-RG: 30.12.1996 / 22863, Romania, the Netherlands-RG: 22.8.1988 / 19907, the United Kingdom-RG: 19.10.1088 / 19964, United Arab Emirates-RG: 27.12.1994 / 22154 and Sweden-RG: 30.9.1990 / 20651.

⁶⁷⁹ RG: 25.12.1994 / 22152.

⁶⁸⁰ RG: 7.10.1996 / 22780.

part of the journey. The principle is that the whole journey is considered international and not just that lap of the journey which took place between two states.

In Turkey, two tests apply for the determination of the company's residence, the place of incorporation and the place of effective management⁶⁸¹. When one of these places is within Turkey, the company is resident in Turkey and subject to full tax liability. If both of these places are not within Turkey the company is not resident in Turkey and subject to limited tax liability on some Turkish-source income.

In the Turkish system to have a place of business or have a permanent representative and to have an income from this place of business or through this permanent representative is a condition for becoming subject to tax for foreign companies who have limited liability⁶⁸².

Under the Tax Procedures Act Article 156 some places are listed as places of business. Other than the places mentioned in the Models, the followings are also included as a permanent establishment:

- department stores or shops
- medical consulting rooms
- warehouses
- hotels
- cafes
- recreation and sport centres
- agricultural land
- vineyards
- orchards
- farms
- plant for raising and processing animals

⁶⁸¹ CTA, Article-9.

⁶⁸² *Supra.*, p.171.

- shipping ticket counters

Those are only examples and are not limited.

In Turkey, a treaty is incorporated after the approval of Turkish Grand National Assembly, the Board of Ministers and the Head of the Turkish Republic⁶⁸³.

3- Taxation of international transportation companies' income

The system adopted by Turkey eliminates the difficulty of discovering the foreign companies' actual income and expenses, regarding different routes and price ranges. It taxes only a percentage of income, the percentage depending on the type of transportation involved. Because of the nature of international transportation it is difficult to determine which part of the transportation is within Turkey.

Two main articles in the Corporation Tax Act relate to foreign transportation companies: Articles 18 and 19. Article 18 of the Corporation Tax Act states that the foreign companies' Turkish-source taxable income is calculated by reference to three different rates for sea, air and land transportation. Article 19 of the Corporation Tax Act determines to which income this treatment applies as follows:

1- For land transportation, carriage within Turkish borders -and therefore Turkish source income- includes revenue from passengers, cargo and baggage and other services provided under the ticket.

2- For air and sea transportation, all income from the carriage between the embarkation port in Turkey and the disembarkation port in a foreign country or transfer to another company's ship in a foreign country's port within the context of international transportation is considered Turkish-sourced. This includes revenue from passengers, cargo and baggage, and all services provided under the ticket.

3- For transportation that takes place outside Turkey, the income from ticket sales within Turkey on behalf of other corporations and all kinds of related income are subject to Turkish tax.

⁶⁸³ The Constitution of Turkish Republic-1982, Articles 87-89 and 90.

Today the applicable rates are as follows⁶⁸⁴:

% of income subject to tax

Sea transportation	15 %
Air transportation	5 %
Land transportation	12 %

In other words, for sea transportation 85%, for air transportation 95% and for land transportation 88% of the foreign companies' income are treated as their expenses.

The figure obtained after applying the corresponding rate is subject to corporation tax of 25%.

Example: A is a foreign transportation company and its income in 1995 was as follows:

1- Sea transportation	28,000,000.- TL
2- Air transportation	44,000,000.- TL

How much tax must A pay?

	<u>Sea</u>	<u>Air</u>
1- Total income	28,000,000.-	44,000,000.-
2- Rates	15 %	5 %
3- Amount subject to tax (1x2)	4,200,000.-	2,200,000.-
4- Corporation tax	25 %	25 %
5- Tax to pay	1,050,000.-	550,000.-

Total: 1,600,000.- to pay.

The Finance Ministry is the authority competent to determine which rates apply. The Finance Ministry can change the rates, but once set the rate must remain at that figure for a whole year before it can be changed again. After this period if it chooses to modify tax rates, the Finance Ministry must publish the new rates in the Official

⁶⁸⁴ The Corporation Tax Act Application Directory, No. 19.

Gazette. At the beginning of the calendar year following the publication date, the new rates will apply to all transportation income of foreign transportation companies⁶⁸⁵.

The rates can be reduced separately or altogether as far as 0 %; or they can be increased, but not to more than double the existing rates established by the Board of Ministers⁶⁸⁶. Also if there is an agreement between two countries, the corporation tax that applies to the foreign transportation companies' income will be reduced to 0%. Today this reduction applies to Bahreyn⁶⁸⁷, Israel⁶⁸⁸, Katar⁶⁸⁹, Oman⁶⁹⁰, Switzerland⁶⁹¹, the United States⁶⁹², United Arab Emirates⁶⁹³ and Saudi Arabia but in the last case it is restricted to the operations of Saudia, the Saudi national airline company⁶⁹⁴.

4- Turkish-source income

a- Journeys originating in Turkey

For sea and air transportation the important point to consider for the purposes of tax calculation is the point of embarkation of the passengers or the beginning of transportation for goods. The final destination is not important. If the beginning of the transportation of goods or the embarkation of passengers is in Turkey, this income is treated as Turkish source income and subject to corporation tax.

⁶⁸⁵ CTA, Article-18.

⁶⁸⁶ CTA, Article-25.

⁶⁸⁷ The Board of Ministers Decision, No.1997/9186 (RG: 29.4.1997 / 22974) (Air transportation).

⁶⁸⁸ The Board of Ministers Decision, No.1992/3078, 20.5.1992 (RG: 28.5.1992/21241) (Sea and air transportation).

⁶⁸⁹ The Board of Ministers Decision, No.1997/9186 (RG: 29.4.1997 / 22974) (Air transportation).

⁶⁹⁰ Idem.

⁶⁹¹ The Board of Ministers Decision, No.1989/14919, 27.12.1997 (RG: 30.12.1989/3078) (Air transportation).

⁶⁹² The Board of Ministers Decision, No.1986/11330, 23.12.1986 (RG: 31.12.1986/19228) (Sea and air transportation).

⁶⁹³ The Board of Ministers Decision, No.1997/9186 (RG: 29.4.1997 / 22974) (Air transportation).

⁶⁹⁴ The Board of Ministers Decision, No.1987/11812, 27.4.1987 (RG: 6.6.1987/ 19479) (Air transportation).

As article 19 of the Corporations Tax Act indicates, for sea and air transportation, from the embarkation point of Turkey to the disembarkation port abroad or on another company's ships or aircraft, all the income is treated as Turkish source income (this includes, for instance, ticket cost for passengers, goods, or baggage or other expenses). The rates outlined in article 18 of the Corporations Tax Act then apply.

Here are some examples⁶⁹⁵ of journeys originating in Turkey:

1- On direct flight from Istanbul to London, all the ticket prices for the passengers, goods and baggage are treated as sourced in Turkey. If the same company take the passengers, goods and baggage to Paris first, and then transfers them onto another company's aircraft, which then goes to London, only the Istanbul-Paris part of the income will be subject to corporation tax in Turkey. Even if the company that is in charge of the Paris-London part of the transportation has a subcharter agreement with the main company, only the Istanbul-Paris part of the transportation is subject to corporation tax. If the same company carries the passengers, goods and baggage from Istanbul-Paris and Paris-London, but uses different aircraft which both belong to the company, all the transportation income from Istanbul to London is subject to corporation tax.

If the ticket price includes both segments of the trip, Istanbul-Paris and Paris-London - in other words if a fixed price was on the ticket from Istanbul to London - all the income from Istanbul to London is subject to corporation tax. If the price has been divided on the ticket between Istanbul-Paris and Paris-London, only the Istanbul-Paris part of the journey will be subject to corporation tax.

If a passenger has two separate tickets for Istanbul-Paris and Paris-London, two different contracts between the passenger and the company exist. Even if the passenger pays the Paris-London part of the ticket price in Turkey, this part of transportation is not subject to corporation tax. If the passenger goes from Istanbul to London directly and the landing in Paris occurs because of a technical necessity, in this context all transportation between Istanbul-London will be subject to corporation tax.

2- If the passenger has a return ticket, Ankara-London and London-Ankara, and even if he paid one price for these two separate journeys, only the Ankara-London part

⁶⁹⁵ Mehmet Mac, *Kurumlar Vergisi*, Denet Yayıncılık A.Ş., Istanbul-1996, Sections 19.6 - 19.8.

of the ticket will be subject to corporation tax. This income is considered to be half of the ticket price.

If the plane goes first from Ankara to Istanbul, then from Istanbul to London, the income from carrying passengers, goods and baggage from Ankara to London is subject to corporation tax. The income from passengers, goods and baggage joining the transportation at Istanbul is subject to Turkish corporation tax only for the destination from Istanbul to London, provided different price range exists for Ankara-London and Istanbul-London.

If the aircraft goes from London to Ankara and if some passengers, goods or baggage disembark in Istanbul, the Istanbul-Ankara part of the transportation will not be subject to corporation tax.

3- Another example of air transportation: this time between London and Bombay, offers other possibilities. If the passenger has a ticket from London to Bombay via Istanbul and if he only transfers to another plane in Istanbul or just waits in the transit passengers lounge, this transportation is not subject to corporation tax. If the same passenger first comes to Istanbul from London, stays in Istanbul for couple of days and then goes to Bombay from Istanbul, the second leg of transportation, i.e. from Istanbul to Bombay, will be subject to corporation tax.

The High Court has decided that the fact that the transportation agreement and the issuing and payment of ticket takes place outside Turkey does not prevent the income from being subject to corporation tax. Income from any transportation, except transit transportation, that stops in Turkey, then goes on to another place or goes back to the first place, is held to be in Turkey and will be subject to corporation tax⁶⁹⁶.

The same rules apply to sea transportation.

b- Ticket sales in Turkey

Commission from ticket sales in Turkey is taxed. If a foreign transportation company sells tickets inside Turkey for passengers and goods or any other transportation facilities for sea, air or land transportation, and receives commission from

⁶⁹⁶ Danistay, 4. Section, Decision No's. 1975/21449 and 1976/101.

those, the commission is treated as sourced in Turkey, irrespective of the place of transportation⁶⁹⁷.

5- Ancillary Activities

This section considers whether certain types of income fall within the definition of transportation income.

Where the ticket price includes the cost of embarkation, disembarkation, transfer and insurance the whole ticket income is treated as the income of the foreign transportation company. If such expenses are paid separately by the passenger or the owner of the goods, the payments are not treated as the income of the transportation company. For example, the cost of food and drinks supplied to the passenger during the transportation is normally within the ticket price. Even if such costs are itemised separately on the ticket, still they are treated as transportation income⁶⁹⁸.

Other types of transportation expenses also exist. One of them is *primaj*, a sum payable to the agent by the person who is paying transportation costs for extra care during embarkation and disembarkation. This is taxed as the income of the agent, and not of the foreign transportation company⁶⁹⁹, even if it is paid directly to the company and the company passes it onto the agent. If the foreign transportation company keeps the *primaj*, it is treated as the transportation income of the company⁷⁰⁰.

Yet another kind of income exists, *surastarya* or *demuraj*. If embarkation or disembarkation takes a longer time than expected, or if unexpected problems arise in the port while the ship is waiting for embarkation or disembarkation, for that waiting period the transportation company may claim extra money from the charterer. This is not covered by the normal transportation cost that the owner of the goods pays to the transportation company, and is not treated as taxable income⁷⁰¹.

Transportation income does not include outlays paid on behalf of the passenger or owner of the goods which is subsequently recovered by the company from the passenger or owner. It is much easier for the transport company to pay expenses than to request payment from the passenger or the owner of the goods. It is a kind of advance payment on behalf of the passenger or the owner of the goods. In this context,

⁶⁹⁷ CTA, Article-19(3).

⁶⁹⁸ Mac, op. cit., Section 19.13.

⁶⁹⁹ Danistay, 4. Section, Decision No. 1970/5300.

⁷⁰⁰ Danistay, 4. Section, Decision No. 1977/728.

⁷⁰¹ Mac, op. cit., Section 19.14-19.15.

such income should not be included in transportation income⁷⁰². Transportation tax and stamp duty for which the owner of the goods is responsible are not to be considered income of the foreign transportation company⁷⁰³.

6- Transit Transportation

Given the nature of transit transportation, the beginning of transportation is, by definition, not within Turkey. Also, it is not intended that the passenger or cargo stay in Turkey. Therefore the income from this transportation is not subject to the corporation tax. However, if the passenger or cargo comes and remains in Turkey and then goes to another destination outside Turkey with the same or another company, two different journeys are considered to have taken place. The second one, which began in Turkey, is subject to tax. If the passenger or cargo changes company in Turkey, this is again considered to be two transportations and the income from second transportation that began in Turkey will be subject to corporation tax⁷⁰⁴.

The only exception to this rule is *free trade zones*. If the transportation continues in such an area it qualifies as transit transportation, even if the cargo stays there some time or changes its carrying company⁷⁰⁵.

7- Leasing

When lease income arises from a ship or aircraft leased to a company in Turkey by the transportation company this income is not taxed as Turkish source transportation income. Instead, subject to any relevant double taxation agreement, it will be subject to withholding at source as follows:

- For financial leasing 1%
- For other leasing 20%⁷⁰⁶.

If the foreign owner of the ship or aircraft has a branch in Turkey, there is no need to withhold the tax at source⁷⁰⁷, because the branch will be taxed on the full amount of the lease income.

⁷⁰² Mac, op. cit., Section 19.13.

⁷⁰³ Danistay, 4. Section, Decision No. 1961/1961.

⁷⁰⁴ Mac, op. cit., p.19.16.

⁷⁰⁵ The Free Trade Areas Regulation, Article-31, RG:10.3.1993/21520.

⁷⁰⁶ CTA, Article-24. The Board of Ministers Decision, No.1993/5147 (RG: 31.12.1993/21805M).

⁷⁰⁷ CTA, Article 12 and 24.

8- Branches and Agencies

If a foreign company sets up a Turkish branch, it applies to the tax office for tax registration. The corporation tax rules concerning foreign transportation companies apply to these branches⁷⁰⁸. If they are dealing with kinds of business other than transportation in Turkey, the branches must keep all necessary books for accountancy rather than only an income book for transportation income, and they will pay the appropriate taxes depending on the nature of the business carried on.

The agencies organise embarkation and disembarkation facilities and complete the formal paperwork on behalf of that foreign transportation corporation since they are permanent representatives of the foreign corporation. The agencies have to complete the tax forms and return them to the tax offices on behalf of the foreign transportation company. They must register their books and pay their taxes. Failure to do these things entails liability and they face possible penalties and sanctions⁷⁰⁹.

9- Income Book

The form of the foreign transportation company is important from the perspective of reporting its position to the tax administration office in order to pay its taxes. The foreign transportation company can have two different forms:

- 1- It trades permanently in Turkey.
- 2- It trades temporarily in Turkey.

In the first category, the company must have a place of business in Turkey or must have a person there to represent it. Article 207 of Tax Management Act-1961 stipulates that, "the foreign transportation companies or their branches or agencies must write in detail all their income which is held in Turkey in an *income book*. For transportation companies it is not necessary to have other books that other companies have for accountancy".

Also article 19 of the Corporation Tax Act says that the company's business must be regular for this book to be required. Maintaining this income book is sufficient from the point of view of taxation. The company does not need to write its expenses and keep the receipts and invoices concerning these expenses.

⁷⁰⁸ CTA, Article 19 and 27.

⁷⁰⁹ CTA, Articles 12 and 27(3).

Each year, this income book must be approved by a notary before the beginning of the tax term. At the end of the calendar year, the rates outlined in Corporation Tax Act Article 18 apply to the total income of the transportation company shown in the book. Then following year in April the company will apply to the tax administration to pay its tax based on this amount⁷¹⁰.

In the second form, the company possesses transportation facilities in Turkey temporarily if it has not a place of business or a permanent representative in Turkey. For this reason, in contrast with the first form, the person who pays money to the foreign company for transportation business must inform the tax administration and pays 25 per cent tax by withholding within 30 days of earning its income.

10- Land Transportation

If land transportation is within Turkey the income from the carrying activities will be subject to corporation tax. But, where the transportation

- begins abroad and finishes in Turkey, or
- begins in Turkey and finishes abroad, or
- begins abroad, passes through Turkey, and finishes at a location abroad (transit transportation)

it is uncertain whether this transportation is land transportation "within Turkey".

Unfortunately, the Courts have not considered this issue. In my opinion, if the government wants to tax these profits, the Turkish part of the journey must be measured and apportioned as part of the total journey and only the income relative to this part would be subject to tax. In practice, to apportion the distance within Turkey will be very difficult.

Therefore the only practical solution is to tax only that income from transportation which both begins and ends within Turkey. In practice, no corporation tax is imposed on transportation that is not solely within the borders of Turkey⁷¹¹.

⁷¹⁰ CTA, Articles 220-226.

⁷¹¹ Mac, op. cit., Section-19.5.

In actual fact the Turkish government charges fees for foreign lorries using Turkey for transit and derives income from transportation. Therefore the need to derive direct taxation from income is not so pressing.

11- Pipeline Transportation

The transportation of oil, natural gas etc. to Turkey through pipelines has a special importance. The carrying of oil within a pipeline has further increased in importance after the decision of United Nations to allow Iraq to sell some part of its oil through Turkey for the first time since the Gulf War. From the perspective of tax law, if this oil enters Turkish ports and is carried by foreign transportation companies abroad, the income from carrying activities will not be subject to tax in Turkey.

The Turkish High Court stated that, since the agreement concerning carrying oil from Turkish ports to Yugoslavia was not signed in Turkey; since neither the carrying company nor the purchaser of the oil is Turkish; and since loading of oil is not made by a Turkish company or agent, it is not possible to tax the foreign transportation company in Turkey⁷¹². A similar situation arose, in another case⁷¹³ although the route was from Turkey to Piraeus (Greece), and again the High Court decided that this income was not subject to Turkish Corporation Tax.

In Turkey interesting area is the pipeline transportation. Despite this type of transportation is not included in Article 8 of the OECD and the United Nations Model, regarding Turkey's geographic situation is quite important type of transportation. After recent United Nations decision allowing Iraq to sell oil first time since Gulf War, the pipeline transportation gained importance again.

However, under two decions of the Danistay, Turkish High Court, in 1981 and 1982⁷¹⁴, the income of international transportation company from the pipeline transportation is not subject to tax in Turkey. In terms of Turkish Corporation Tax Act, the foreign companies' Turkish-source income from the transportation between the embarkation point and the disembarkation point is Turkish-sourced and subject to tax.

⁷¹² Danistay, 13. Section, Decision No.1981/1202.

⁷¹³ Danistay, 4. Section, Decision No.1982/623.

⁷¹⁴ *Supra.*, p.186.

Under these circumstances, when a international transportation company load an oil from Turkish port it should be a Turkish-source income and subject to Corporation tax.

However, the High Court decided the income from transportation of oil between Turkish port and a foreign port is not subject to tax. Interesting point when reaching this result the Court have examined different possibilities. They expressed that:

- 1- The carriage agreement was not signed in Turkey.
- 2- Neither the carrying company nor the purchaser of the oil is Turkish.
- 3- The loading of oil not made by any Turkish company in Turkey.

A year later the Court has made the same decision for a similar situation in another case.

After the decision the question to ask is why the Court did not check whether the loading point is in Turkey. Instead of this important question to decide whether the foreign company is subject to tax in Turkey, the Court preferred to research the connection of any other points with Turkey.

The problem is closely related with the nature of the pipeline transportation. In this type of transportation an oil, also a natural gas is possible, from Iraq is being transported to Turkish ports and then loaded directly to the ships to be carried out. The point should be discussed is whether loading point and activity sufficient to be Turkish-source. At that point presumably the Court thought that the oil is coming directly to the Turkish port and without unloaded in the port is being loaded into the foreign company's ships. May be it was very obvious for the Court that the pipeline was carrying oil from Iraq to the ship directly and for this reason it was not a Turkish-source.

First, despite it looks clear for the Court that the carrying oil by pipeline was not within the concept of a Turkish-source income, they should discuss this point than the other points. Secondly, I do not agree with the Court. Because, whenever this oil is crossing the Iraq-Turkey border it is within the Turkey. When a pipeline has a connection with the land the carrying activities have been made in Turkey. Another point is, when the oil have been reached the Turkish ports, despite it is still in the pipe, it has been waited in the port to be loaded. In practice I can not see any difference then, for exemple, a container which has been loaded with oil and waiting for to be carried or to be sold. Also, it is possible that the oil have been depoted in somewhere for a future

loading or selling. Regarding these possibilities I think that the loading an oil from Turkish ports is a Turkish-source activity therefore, the income from this transportation should be subject to Turkish corporation tax.

The reason may be related with political preferences. In terms of international competition in the oil market to tax those income, would be extra cost for the companies. For this reason it is possible to prefer other countries to buy an oil for international companies. May be it was the reason not to tax these income to make buying oil from Turkey which make the market attractive without extra cost. Whatever the reason, under existing tax law the decision should be made in the opposite way.

CHAPTER VII: THE UNITED KINGDOM

1- Introduction

In general, a company resident in the United Kingdom pays corporation tax on its profits wherever arising⁷¹⁵. A company means any body corporate or unincorporated association but does not include a partnership, a local authority or a local authority association⁷¹⁶.

For the financial year 1996 the rate of tax is 33%. If the company's profits do not exceed £300,000, a special lower rate is applied which is 24% and it will be reduced to 23% from 1.4.1997 under the 1997 Finance Bill. Also, for profits between £300,000 and £1,500,000, tapering relief is available.

Non-United Kingdom resident are subject to United Kingdom tax on certain profits if they carry on a trade in the United Kingdom⁷¹⁷.

2- The United Kingdom Double Taxation Treaties

The first United Kingdom double tax treaty was with the Swiss Canton of Vaud in 1872⁷¹⁸ and concerned inheritance taxes. A treaty was concluded in 1899 between the United States and Great Britain⁷¹⁹, and in 1907 a treaty was concluded between France and Great Britain⁷²⁰.

⁷¹⁵ Income and Corporation Taxes Act 1988 (Hereinafter cited as ICTA 1988), s.8(1).

⁷¹⁶ ICTA 1988, s.832(1) and (2).

⁷¹⁷ Chris Whitehouse, *Revenue Law: Principles and Practice*, Butterworths, Edinburgh-1996, p.538; Geoffrey Morse-David Williams-David Salter, *Davies: Principles of Tax Law*, Sweet & Maxwell, London-1996, pp.461-463; J.F. Avery Jones: "Does the United Kingdom Give Credit for Tax on a Permanent Establishment Abroad?", *British Tax Review*, 1994, No.3, pp.191-203.

⁷¹⁸ The League of Nations Document, E.F.S.26, F.7/8.

⁷¹⁹ The League of Nations Document, E.F.S.26, F.7/7.

⁷²⁰ The League of Nations Document, E.F.S.26, F.7/9.

However, the first double taxation problem appeared earlier in 1860, when India introduced an income tax⁷²¹ that resulted in the United Kingdom residents being taxed both in India and in the United Kingdom. Although there was an obvious practical difficulty, there seemed to be no political will to find a solution.

Such problems appeared again in 1893 when a number of countries within the British Empire introduced taxes on income⁷²². The British Parliament debated the question of double taxation at various times between 1896 and 1911, but the government resisted proposed amendments to Finance Acts.

Before the First World War, income taxes in general were very low internationally and double taxation was not much of a problem. However, during the First World War, when taxes were increased⁷²³ both in the United Kingdom and elsewhere in the British Empire, the problem of double taxation arose again⁷²⁴.

In 1917, the Imperial War Conference resolved that there should be a review of double taxation within the Empire when the War was over. The Royal Commission undertook a review of income tax in 1919. The Royal Commission had set up a special sub-committee with representatives of the Dominions to study double taxation problems. The subcommittee stated that⁷²⁵:

"...having regard to the essential homogeneity of the Empire, there is an inequity in requiring the taxpayer to make contributions of income tax towards what must certainly in part be a common purpose, viz., the well-being of the British Empire."

In the 1920 Finance Act, a system of "Dominion Income Tax Relief" as proposed by the Royal Commission, was adopted. The expression "Dominion" was defined as meaning any British possession or any territory that is under His Majesty's

⁷²¹ Davies, op. cit., p.28; Picciotto, op. cit., p.14.

⁷²² Davies, op. cit., p.29.

⁷²³ Michael Z. Hepker, *A Modern Approach to Tax Law*, Heinemann, London-1973, p.16.

⁷²⁴ Davies, op. cit., p.29.

⁷²⁵ The Royal Commission on the Income Tax, Cmd. 615(1920) Appendix 7(c), para.'s-2 and 15; Davies, op. cit., pp.29-30.

protection or in respect of which a mandate is being exercised by the Government of any part of His Majesty's Dominions.

Under this system, if the income of the taxpayer were taxed in the United Kingdom and in the Dominion, some relief would be given. This relief would be up to one half of the United Kingdom tax rate, or the amount of the Dominion tax rate, depending upon the tax rate that was the lower⁷²⁶.

The Finance Act 1923 permitted reciprocal relief from tax on shipping profits⁷²⁷. This was extended to air transport by the Finance Act of 1931⁷²⁸.

In the inter-war years the United Kingdom signed some limited double taxation treaties⁷²⁹ relating to shipping, air transport and agencies. They were based on the residence principle - viz. reciprocal exemption of taxation by the country of source⁷³⁰.

With the exception of the agreement with Ireland in 1926⁷³¹, the United Kingdom was unable to conclude any comprehensive double tax treaties until 1945 when there was a change in policy, away from the residence principle to which it had adhered for those 19 years.

In those years without any comprehensive double taxation agreements, United Kingdom businesses had an disadvantage against foreign corporations. After adoption of the source principle in 1945, the United Kingdom signed its first comprehensive

⁷²⁶ The Finance Act-1920, Section 27(8); see J.W. Scobell Armstrong, *The Taxation of Profits*, Virtue & Co. Ltd., London, 1937, pp.80-81; Philip Shelbourne: "Double Taxation and Its Improvement", *British Tax Review*, 1957, p.49.

⁷²⁷ The Finance Act-1923, S.18.

⁷²⁸ The Finance Act-1931, S.9.

⁷²⁹ Such treaties were concluded with the United States, Denmark, France, Germany, Japan, the Netherlands, Norway and Sweden.

⁷³⁰ Davies, op. cit., p.31.

⁷³¹ The Agreement between the British Government and the Government of the Irish Free State in Respect of Double Income Tax, 14.4.1926, reprinted in League of Nations Document, C.345, m.102, 1928 II; see Davies, op. cit., p.31; Vogel, op. cit., p.8; Picciotto, op. cit., p.20.

agreement with the United States⁷³². In the next eight years over 50 double tax treaties entered into force⁷³³.

In 1950, Dominion Tax Relief was abolished by the 1950 Finance Act⁷³⁴ and a new system of unilateral relief was introduced which gave credit for overseas tax.

The United Kingdom has concluded some limited agreements granting reciprocal tax exemption. Some of them apply to income derived from air traffic, and are with Algeria, Cameroon, Ethiopia, Iran and Kuwait. Some apply reciprocal tax exemption to income derived from air traffic or the operation of the ships, and are with Argentina, Brazil, Jordan, Liberia, Venezuela and Zaire. One agreement, applying only to income derived from shipping, is with Iceland⁷³⁵.

From 1963, the United Kingdom followed the OECD Models that adopt the residence principle⁷³⁶.

In the United Kingdom treaties do not become a part of domestic law after the ratification⁷³⁷. A double taxation agreement is brought into effect by statutory instrument⁷³⁸. In the event of conflict between treaty and United Kingdom domestic law, the treaty has priority⁷³⁹. If a double taxation agreement does not exist, the unilateral relief will apply⁷⁴⁰.

The United Kingdom uses two types of double taxation treaties: "Colonial Model" treaties and "OECD-based" treaties⁷⁴¹.

⁷³² S.R.&O. No.1327 of 1946; For details see: Picciotto, op. cit., pp.39-41.

⁷³³ Davies, op. cit., p.32.

⁷³⁴ Finance Act-1950, S.36.

⁷³⁵ Davies, op. cit., p.137.

⁷³⁶ John Tiley, Revenue Law, Butterworths, London-1981, p.675; Alan Cinnamon-Rodney Taylor: "Double Trouble!", *Taxation International*, July-1990, p.70.

⁷³⁷ Baker:90, op. cit., p.21.

⁷³⁸ Income and Corporation Taxes Act-1988, s.788(1) (Hereinafter referred as ICTA).

⁷³⁹ ICTA-1988, S.788(3). For example see: *Ostime v. Australian Mutual Provident Society* (1960) AC 459 and *Sun Life Insurance Co. of Canada v. Pearson* (1986) STC 335.

⁷⁴⁰ ICTA-1988, s.790.

⁷⁴¹ Davies, op. cit., pp.135-136.

a- Colonial Model Treaties

In Colonial Model treaties, the residence principle is used for international shipping and air transport. This is the main difference from the OECD based treaties which use the place of effective management. The Colonial Model applies to all air and sea transport operations, including transportation carried out by an enterprise in the treaty state solely between destinations in the other treaty state.

The double tax treaties with Italy⁷⁴² and Pakistan⁷⁴³ follow the residence principle but, in addition, require that the ships and aircraft be registered in the state where the enterprise is resident. The treaty with Greece⁷⁴⁴ makes a similar requirement, which covers only ships. The treaty with Burma⁷⁴⁵ does not give the source country an exemption for air or shipping operations within the territory, and the Malawi⁷⁴⁶ treaty excludes from the exemption ships operating wholly in inland waters. The treaty with New Zealand⁷⁴⁷ uses the residence principle.

The Colonial model does not cover inland waterways and does not refer to participation in pooling agreements, but these operations do not seem to be precluded⁷⁴⁸.

b- OECD-Based Treaties

The OECD-based United Kingdom double taxation apply the residence⁷⁴⁹ and the effective management principle⁷⁵⁰.

⁷⁴² 21.10.1988, SI: 1990/2590.

⁷⁴³ 24.4.1961, SI: 1961/2467.

⁷⁴⁴ 25.6.1953, SI: 1954/142.

⁷⁴⁵ 13.3.1950, SI: 1952/751.

⁷⁴⁶ 25.11.1955, SI: 1956/619.

⁷⁴⁷ 4.8.1983, SI: 1984/365.

⁷⁴⁸ Davies, op. cit., p.136.

⁷⁴⁹ With Austria-30.4.1969, SI: 1970/1947, Azerbaijan-23.2.1994, SI: 1995/762, Bangladesh, Belarus--7.3.1995, SI: 1995/2706, Canada-8.9.1978, SI: 1980/709, Estonia-12.5.1994, SI: 1994/3207, Finland-17.7.1969, SI: 1970/153, France-22.5.1968, SI: 1968/1869, Ghana-20.1.1993, SI: 1993/1800, Guyana-31.8.1992, SI: 1992/3207, India-16.4.1981, SI: 1981/1120 (shipping only), Indonesia-5.4.1993, SI: 1994/769,

The treaty with the Philippines⁷⁵¹ does not contain a shipping or air transport article. International air transport and shipping is taxed in the Philippines according to national law⁷⁵². The Philippines imposes a gross billings tax on international carriers and do not have any international transport clauses in its double taxation agreements with developed countries, including the United Kingdom.

Foreign airlines and shipping companies operating in the Philippines are not comfortable with this situation⁷⁵³, because, they are not granted any relief on their transportation income under the Philippines gross billings tax.

After 1992 amendments of the OECD Model, the United Kingdom reserves the right to include in paragraph 1 of the Article 8 profits from the leasing of a ships or aircraft on a bare boat basis⁷⁵⁴ and from the leasing of containers⁷⁵⁵.

Kazakhstan-21.3.1994, SI: 1994/3211, Malta-12.5.1994, SI: 1995/763, Mexico-2.6.1994, SI: 1994/3212, Mongolia-23.4.1996, SI: 1996/Draft, the Netherlands Antilles-31.10.1967, SI: 1968/577, New Zealand, Papua New Guinea-17.9.1991, SI: 1991/2882, Portugal-27.3.1968, SI:1969/599, Russian Federation-15.2.1994, SI: 1994/3213, Turkey-19.2.1986, SI: 1988/932, Ukraine-10.2.1993, SI: 1993/1803, Union of Soviet Socialist Republic-3.5.1974, SI: 1974/1269, the United States-31.12.1975, SI: 1980/568, Uzbekistan-15.11.1993, SI: 1994/770, Venezuela-11.3.1996, SI: 1996/Draft and Vietnam-9.4.1994, SI: 1994/3216.

⁷⁵⁰ With Bangladesh-8.8.1979, SI: 1980/708 (air only), Belgium-1.6.1987, SI: 1987/2053, Bolivia-3.11.1994, SI: 1995/2707, Bulgaria-1.6.9.1987, SI: 1987/2054, China-10.3.1981, SI: 1981/1119, Czechoslovakia-5.11.1990, SI: 1991/2876, Denmark-11.11.1990, SI: 1980/1960, Egypt-25.4.1977, SI: 1980/1091, Falkland Islands-14.3.1984, SI: 1984/363, Germany-26.11.1964, SI: 1967/25, Iceland-30.9.1991, SI: 1991/2879, Israel-26.9.1962, SI: 1963/616, Italy, Ivory Coast-26.6.1985, SI: 1987/169, Luxembourg-24.5.1967, SI: 1968/1100, Mauritius-11.2.1981, SI: 1981/1121, Namibia-28.5.1962, SI: 1962/2352, the Netherlands-7.11.1980, SI: 1980/1961, Norway-3-10.1985, SI: 1985/1998, Pakistan-24.11.1986, SI: 1987/2058, Poland-16.12.1976, SI: 1978/282, Romania-18.9.1975, SI: 1977/57, Sweden-30.8.1983, SI: 1984/366, Switzerland-8.12.1977, SI: 1978/1408, Thailand-18.2.1981, SI: 1981/1546 (air only), Trinidad and Tobago-31.12.1982, SI: 1983/1903, Tunisia-15.12.1982, SI: 1984/133, Uganda-23.12.1992, SI: 1993/1802, Yugoslavia-6.11.1981, SI: 1981/1815 and Zimbabwe 19.10.1982, SI: 1982/1842.

⁷⁵¹ 10.6.1976, SI: 1978/184.

⁷⁵² Davies, *op. cit.*, p.136, footnote-48.

⁷⁵³ Davies, *op. cit.*, p.136.

⁷⁵⁴ The OECD Commentary on Article 8, para.5.

⁷⁵⁵ *Ibid.*, para.10.

The United Kingdom especially has many agreements which adopt reciprocal exemption⁷⁵⁶. Some of the countries which have adopted reciprocal exemption in their treaties with the United Kingdom are countries which have a similar economic strength as the United Kingdom. Here tax revenues are largely unaffected.

However, many of the treaties which the United Kingdom has signed are with developing countries and here too we see reciprocal exemption being adopted. In these case there is a clear advantage to the United Kingdom and the developing countries will lose much tax revenue, as the United Kingdom will have a more developed shipping and air transport industry.

Except for the treaties with Luxembourg⁷⁵⁷ and Switzerland, there is no reference in the United Kingdom treaties to boats operating in inland waterways⁷⁵⁸.

⁷⁵⁶ With Algeria (air only)- 27.5.1981, SI: 1984/862, Antigua and Barbuda-19.12.1947, SI: 1947/2865, Argentina-3.1.1996 (Not yet in use), Australia-7.12.1967, SI: 1969/305, Barbados-26.3.1970, SI: 1970/952, Botswana-5.10.1977, SI: 1978/133, Brunei-8.12.1950, SI: 1950/1977, Cyprus-20.6.1974, SI: 1975/425, Dominica-4.3.1949, SI: 1949/359, Ethiopia-1.2.1977, SI: 1977/1297, Faroe Islands-27.3.1950, SI: 1950/1195, Fiji-21.11.1975, SI: 1976/1342, Gambia-20.5.1980, SI: 1980/1963, Greece-25.6.1953, SI: 1954/142, Grenada-4.3.1949, SI: 1949/361, Guernsey-24.6.1952, SI: 1952/1215, Hungary-28.11.1977, SI: 1978/1056, India (air only)- 25.1.1993, SI: 1993/1801, Iran (air only)- 21.12.1960, SI: 1960/2419, Ireland-2.6.1976, SI: 1976/2151, Jamaica-16.3.1973, SI: 1973/1329, Japan-10.2.1969, SI: 1970/1948, Jersey-24.6.1952, SI: 1952/1916, Jordan- 6.3.1978, SI: 1979/300, Kenya-31.7.1973, SI: 1977/1299, Kiribati and Tuvalu-10.5.1950, SI: 1950/750, Korea-21.4.1977, SI: 1978/786, Kuwait (air only)- 25.9.1984, SI: 1984/1825, Lebanon-26.2.1964, SI: 1964/278, Lesotho-25.11.1949, SI: 1949/2197, Malawi-25.11.1955, SI: 1956/619, Malaysia-30.3.1973, SI: 1973/1330, Montserrat-19.12.1947, SR&Q: 1947/2869, Myanmar (formerly Burma)- 13.3.1950, SI: 1952/751, Nigeria-9.6.1987, SI: 1987/2057, St. Christopher (St. Kitts) and Nevis-19.12.1947, SR&Q: 1947/2872, St. Lucia-4.3.1949, SI: 1949/366, St. Vincent and the Grenadines-4.3.1949, SI: 1949/367, Saudi Arabia (air only)- 10.3.1993, SI: 1994/767, Seychelles-8.8.1947, SR&Q: 1947/1778, Sierra Leone-19.12.1947, SR&Q: 1947/2873, Singapore-1.12.1966, SI: 1967/483, Solomon Islands-10.5.1950, SI: 1950/748, South Africa-21.11.1968, SI: 1969/864, Spain-21.11.1975, SI: 1976/1919, Sri Lanka-21.6.1979, SI: 1980/713, Sudan-8.3.1975, SI: 1977/1719, Swaziland-26.11.1968, SI: 1969/380, Zaire-11.10.1976, SI: 1977/1298 and Zambia-22.3.1972, SI: 1972/1721.

⁷⁵⁷ 24.5.1967, SI: 1968/1100.

⁷⁵⁸ The OECD Model, Article 8(3).

Road and/or rail transport are included within the definition of "international traffic" in, for example, the following: the United Kingdom double taxation treaties⁷⁵⁹ with Bulgaria, Mongolia, Poland, Romania, Turkey and Uzbekistan; some German double taxation treaties with Austria and Belgium; the United States double taxation treaties⁷⁶⁰ with Canada and Honduras; and some Turkish double taxation treaties⁷⁶¹ with Belgium, Denmark, France, Finland, Germany, Hungary, Jordan, the Netherlands, Northern Cyprus, Norway, Romania, Sweden, United Arab Emirates and the United Kingdom⁷⁶².

If there is no definition in the treaty⁷⁶³, the term "international traffic" will be interpreted according to the relevant national laws of the Contracting States⁷⁶⁴. The term "international traffic" has not been defined in United Kingdom double taxation agreements, for example, with Austria, Canada and Papua New Guinea; Turkish double taxation agreements with Austria and Norway; Canadian double taxation agreements with Belgium, France, Ireland, Luxembourg, Norway, Romania and Switzerland; United States double taxation agreements with Denmark and Switzerland⁷⁶⁵.

The United Kingdom-Turkey double taxation agreement correctly uses the heading "international transport". However, in the definition section of this agreement international transport includes on shipping, air and road transportation.

In the United Kingdom-Union of Soviet Socialist Republic double taxation agreement the heading of Article 8 is "profits from international traffic" and the definition of international traffic includes shipping, air transportation, motor vehicle and railway.

⁷⁵⁹ Supra., pp.193-195.

⁷⁶⁰ Walter A. Slowinski - Thomas M. Haderlein - Dennis I. Meyer: "International Tax Treaties: Where Are We? - Where Are We Going?", *Virginia Journal of International Law*, Vol.5(1964-1965), p.155 (footnote-120). They use the term "motor vehicle operation".

⁷⁶¹ Supra., p.171.

⁷⁶² RG: 19.10.1988 / 19964.

⁷⁶³ See United Kingdom-Austria, United Kingdom-Canada, Turkey-Austria and Turkey-Norway.

⁷⁶⁴ Davies, op. cit., p.141; See for interpretation, supra., p.2.

⁷⁶⁵ Infra., p.236.

Under the United Kingdom-Thailand double taxation agreement Article 9 only deals with air transport despite the definition of international traffic including shipping and air transportation.

In the United Kingdom-Mexico double taxation agreement international traffic does not include any direct delivery of goods or merchandise to a consignee by inland surface transport, the inland surface transport of individual and the provision of accommodation.

In the United Kingdom, the government is anxious to support the shipping industry. The Report of the Joint Working Party in 1990, for the prevention of increasing cost of capital to shipping made four important suggestion:

1- Direct investment grants to shipping companies for new and/or second-hand ships. These are available in some form in France, the Netherlands, Korea and Taiwan. Also grants to shipyards may assist shipowners.

2- Soft loans with low interest rates or moratoria financed by government.

3- Tax position of shipping companies where the government provides for accelerated depreciation allowances, low or zero corporation tax, and availability of tax free reserves depend on the rate of corporation tax --the higher the tax rate the greater the benefit to the company. These benefits exist in some form in many EC and Nordic countries and in Japan among others.

4- Favourable tax treatment of individuals and partnerships investing in shipping⁷⁶⁶.

3- Definitions

a- "Branch or agency"

"Branch or agency" means any factorship, agency, receivership, branch or management⁷⁶⁷.

⁷⁶⁶ The Report of the Joint Working Party, *British Shipping: Challenges and Opportunities*, HMSO, London-1990.

b- "Trade"

The term trade includes every trade, manufacture, adventure or concern in the nature of trade⁷⁶⁸.

c- "Business"

The United Kingdom Revenue's view is that "business" has a wider meaning than "trade". Business includes transactions carried out for the purposes of a trade about to be commenced and to the holding of investments, including shares in a subsidiary company⁷⁶⁹.

If a company's transactions have been limited to keeping the company on the register of Companies, it is not carrying on "business"⁷⁷⁰.

d- "United Kingdom"

The United Kingdom includes territorial sea and designated areas of the continental shelf⁷⁷¹.

4- Residence

The concept "resident" is fundamental to the taxation of companies. However, there is no definition of the terms "*resident*" and "*ordinary resident*" in the United Kingdom Taxes Acts. Therefore the decisions of the Courts are extremely important⁷⁷².

⁷⁶⁷ ICTA 1988, Section 834(1).

⁷⁶⁸ ICTA 1988, Section 832(1).

⁷⁶⁹ SP 1/90, 9.1.1990, paragraph 3.

⁷⁷⁰ SP 1/90, 9.1.1990, paragraph 4.

⁷⁷¹ ICTA 1988, Section 830.

⁷⁷² The Inland Revenue, IR 20, *Resident and non-residents: Liability to tax in the United Kingdom*, 1993, paragraph 1.1.

It has been stated in *Salomon v. Salomon & Co. Ltd.*⁷⁷³ that:

"...the definition of the word "residence" is founded upon the habits and relations of the natural man, and is therefore inapplicable to the artificial and legal person whom we call a corporation. But for the purpose of giving effect to the words of the legislature an artificial residence must be assigned to this artificial person, and one formed on the analogy of natural persons."

In the absence of a definition of the term "*resident*" in United Kingdom tax legislation, it is quite common to use the term's dictionary meaning. The definition of the term "reside" is given in *Levene v. IRC*⁷⁷⁴ by Viscount Cave as follows:

"... the word 'reside' is a familiar English word and is defined in the Oxford English Dictionary as meaning 'to dwell permanently or for a considerable time, to have one's settled or usual abode, to live in or at a particular place'. No doubt this definition must, for present purposes, be taken subject to any modification which may result from the terms of the Income Tax Act and Schedules, but, subject to that observation, it may be accepted as an accurate indication of the meaning of the word 'reside'."

Another important term, "*ordinary residence*", is defined in *Shah v. Barnet London Borough Council*⁷⁷⁵ by Lord Scarman that " 'ordinary resident' refers to a man's abode in a particular place or country which he has adopted voluntarily and for settled purposes as part of the regular order of his life for the time being, whether of short or long duration."

As the House of Lords has stated, ordinary residence can only arise if the taxpayer is resident such as in *IRC v. Lysaght*⁷⁷⁶. By contrast, a taxpayer can be ordinarily resident without being resident⁷⁷⁷. For example, if the taxpayer usually lives in the United Kingdom but has gone abroad for an extended holiday and does not set foot in the

⁷⁷³ [1897] AC 22.

⁷⁷⁴ [1928] AC 217.

⁷⁷⁵ [1983] 2 AC 309.

⁷⁷⁶ [1928] AC 234.

⁷⁷⁷ The Inland Revenue, IR20, 1993, para. 1.3.

United Kingdom during the tax year he can still be ordinarily resident in the United Kingdom.

The term "residence" can be explained under two headings;

- The residence of companies registered in the United Kingdom
- The residence of foreign registered companies.

a- The Residence of the Companies Registered in the United Kingdom

Prior to 1988, the only criterion of United Kingdom residence was when the central management and control of the company took place in the United Kingdom as in *Rogers v. IRC*.⁷⁷⁸ If a company's central management and control was exercised abroad, this was different pre 1988 to establish non United Kingdom residence, even if the company was registered in the United Kingdom as in *Egyptian Delta Land and Investment Co. Ltd. v. Todd*.⁷⁷⁹ Thereafter, it was established that a company was also resident if it had been incorporated in the United Kingdom⁷⁸⁰.

In case law the place of "central management and control" is the highest level of control of the business of a company⁷⁸¹. In *Unit Construction Co. Ltd. v. Bullock*⁷⁸², Lord Radcliffe said that "... the question where control and management abide must be treated as one of fact or 'actuality'."

In some cases the importance of the place where the company's board of directors meet is mentioned⁷⁸³. Sometimes the place where the company's board of directors meet and the place where the business operations take place is the same, in which case no question about the central management and control arises⁷⁸⁴.

⁷⁷⁸ [1879] 1 T.C. 225.

⁷⁷⁹ [1929] AC 1.

⁷⁸⁰ The Finance Act-1988, section 66.

⁷⁸¹ Statement of Practice 1/90, 9.1.1990, paragraph 11.

⁷⁸² (1959) 38 T.C. 712.

⁷⁸³ For example, *Union Corp. Ltd. v. I.R.C.*, (1951), 34 T.C. 207.

⁷⁸⁴ SP 1/90, 9.1.1990, paragraph 12.

In *Unit Construction Co. Ltd. v. Bullock*, the three subsidiaries of Unit Construction Co. Ltd., a United Kingdom resident, have been incorporated in Kenya and the local directors of the subsidiaries having never met since, under the association agreement meetings might be held outside the United Kingdom. However, the three subsidiaries were treated as resident in the United Kingdom because the central management and control is exercised in London.

Different criteria can be chosen as a test for the company residence as Lord Radcliffe stated in *Unit Constructions Co. Ltd. v. Bullock*, such as the country of incorporation, the site of general meetings or the site of meetings of the board of directors⁷⁸⁵.

Sometimes an individual has the power to control the company. In this case central management and control is exercised by him, so the place where he uses his power is, at the same time, the residence of the company⁷⁸⁶.

The place where directors' meetings are held is not by itself sufficient to conclude the issue of residence. For example, when a company's business is completely in the United Kingdom and the directors were engaged actively in the United Kingdom, the company has a residence in the United Kingdom. However, if the directors held formal board meetings outside the United Kingdom, this would be insufficient to establish that company has a residence outside the United Kingdom⁷⁸⁷.

The United Kingdom Inland Revenue adopt the following approach to determining a company's status:

1- They first try to ascertain whether the directors of the company in fact exercise central management and control;

2- If so, they seek to determine where the directors exercise this central management and control (which is not necessarily where they meet);

⁷⁸⁵ *Idem*.

⁷⁸⁶ SP 1/90, 9.1.1990, paragraph 13.

⁷⁸⁷ SP 1/90, 9.1.1990, paragraph 14.

3- In cases where the directors apparently do not exercise central management and control of the company, the Revenue then seek to establish where and by whom it is exercised⁷⁸⁸.

United Kingdom registered companies could not cease to be resident in the United Kingdom save with Treasury consent, which was first introduced in 1951; failure to comply was a criminal offence. Without Treasury consent many United Kingdom registered companies were unlawfully non-resident⁷⁸⁹.

After 1988, company migration without Treasury consent was no longer a criminal offence⁷⁹⁰. Also from 15.3.1988 all companies incorporated in the United Kingdom were treated as residents of the United Kingdom⁷⁹¹, for example, if company X is incorporated in the United Kingdom on 16.3.1988 it is treated as United Kingdom resident company, even if the company's central management and control is abroad.

When a company becomes a United Kingdom resident, it is liable to pay corporation tax. If a company wants to be a non-resident it must be registered outside of the United Kingdom such as the Isle of Man or the Channel Islands⁷⁹².

In practice, after the 1988 changes, many companies carrying on business in the United Kingdom moved registration to the Irish Republic where registration does not establish residence⁷⁹³.

b- The Residence of Foreign Registered Companies

If a foreign registered company's central management and control is exercised in the United Kingdom, it will be deemed to be resident in the United Kingdom. As there

⁷⁸⁸ SP 1/90, 9.1.1990, paragraph 15.

⁷⁸⁹ Giles Clarke, *Offshore Tax Planning*, Butterworths, London - 1990, p.17.

⁷⁹⁰ The Finance Act-1988, s.105(6) (Hereinafter referred as FA); ICTA-1988, section-765(1)(a) and (b); see ICTA-1970, section-482(1)-(4).

⁷⁹¹ FA-1988, s.66(1)-(4).

⁷⁹² Clarke, op. cit., p.18.

⁷⁹³ D.S. Roxburgh: "Dissolution of Non-resident Incorporated Companies Before 15 March 1993", *European Taxation*, December 1992, p.425.

is no statutory rule about the residence of non United Kingdom registered companies in the United Kingdom tax code, case law will apply⁷⁹⁴.

c- To determine the residence of the company

When a company is incorporated, for example, in the United Kingdom it is resident in the United Kingdom. If a company is not incorporated in the United Kingdom, the other test, "central management and control" applies to determine the residence of the company.

In the United Kingdom the place in which the company's business is managed and controlled is the basis for determination of the residence of the corporations in the absence of the place of incorporation in the United Kingdom. The term "central management" looks similar to the the term "effective management". Although, the OECD Commentary on Article 4 states that, "...it has been made clear, on the United Kingdom side, that this expression ["its business is managed and controlled"] means the 'effective management' of the enterprise"⁷⁹⁵, for the Inland Revenue "effective management" and "central management and control" may be different from each other⁷⁹⁶.

For example, where a company is run by executives based abroad, but the final directing power rests with non-executive directors who meet in the United Kingdom, the company's place of effective management might be abroad but it might be centrally managed and controlled in the United Kingdom depending upon the precise powers of the non-executive directors⁷⁹⁷.

One of the early cases to determine residence of a company in the United Kingdom goes back to 1876. In *Calcutta Jute Mills Co. v. Nicholson*⁷⁹⁸, the Court decided that the company was resident in the United Kingdom because the directors' meetings took place in the United Kingdom. The company was incorporated in the United Kingdom and was carrying on business in India. The company's books and records were

⁷⁹⁴ *Infra.*, p.225.

⁷⁹⁵ Paragraph 23.

⁷⁹⁶ SP 1/90, paragraph 22.

⁷⁹⁷ SP 1/90, paragraph 22.

⁷⁹⁸ (1876), 1 T.C. 83.

in India. Four of the five directors of the company met in the United Kingdom. For the court this meeting was sufficient to determine the company was resident in the United Kingdom.

An important case in this area is *De Beers Consolidated Mines Ltd. v. Howe*⁷⁹⁹ which was the beginning of the "central management and control" test. In this case Lord Loreburn stated that "a company resides where its real business is carried on" and added that "the real business is carried on where the central management and control actually abides".

De Beers was a company involved in the mining of diamonds in South Africa and was incorporated under the law of that country. The diamonds were sold in London. General meetings took place in Kimberley, South Africa. The majority of its directors resided in England and when problems arose they were referred to London. From London, instructions were sent to South Africa.

The taxpayer argued that because the company was registered in South Africa, it was resident there. Lord Loreburn disagreed. He said that under the central management and control test the conduct of company affairs is more important than its internal regulations. The company was resident in the United Kingdom, because the company's directing power was there. The Lord Chancellor stated that:

"...In applying the conception of residence to a Company, we ought, I think, to proceed as nearly as we can upon the analogy of an individual. A company cannot eat or sleep, but it can keep house and do business. We ought, therefore, to see where it really keeps house and does business. An individual may be of foreign nationality, and yet reside in the United Kingdom. So may a company. Otherwise, it might have its chief seat of management and its centre of trading in England, under the protection of English law, and yet escape the appropriate taxation by the simple expedient of being registered abroad and distributing its dividends abroad.

The decision ...in the *Calcutta Jute Mills v. Nicholson* and the *Cesena Sulphur Company v. Nicholson*, now thirty years ago, involved the principle that a Company resides, for purposes of Income Tax,

⁷⁹⁹ (1906), 5 T.C. 198.

where its real business is carried on. Those decisions have been acted upon ever since. I regard that as the true rule; and the real business is carried on where the central management and control actually abides.

It remains to be considered whether the present case fall within that rule. This is a pure question of fact to be determined, not according to the construction of this or that regulation or bye-law, but upon a scrutiny of the course of business and trading..."

After that, the basis of this decision appeared in many cases, especially in *Unit Construction Co. Ltd. v. Bullock*⁸⁰⁰. Lord Radcliffe expressed the view that this test must be "as precise and unequivocal as a positive statutory injunction" and added:

"I do not know any other test which has either been substituted for that of central management and control, or has been defined with sufficient precision to be regarded as an acceptable alternative to it. To me at any rate, it seems impossible to read Lord Loreburn's words without seeing that he regarded the formula he was propounding as constituting the test of residence."

It is also possible in other cases to see the effect of Lord Loreburn's words and formula he put forward, for instance, in *American Thread Co. v. Joyce*⁸⁰¹, *New Zealand Shipping Co. Ltd. v. The*⁸⁰² and *Bradbury v. English Sewing Cotton Co. Ltd.*⁸⁰³.

In *American Thread Company Limited. v. Joyce*⁸⁰⁴, the company was incorporated in the United States and it was a wholly-owned subsidiary of English Sewing Cotton Co. Ltd. The Commissioners found that the control of management was in the United Kingdom because the board of directors sitting in England were exercising direction over the affairs of the company and for this reason Lord Halsbury decided that the company was a United Kingdom resident.

In the same case Buckley L.J. expressed that:

⁸⁰⁰ (1959), 38 TC 712.

⁸⁰¹ (1913) 6 T.C. 163.

⁸⁰² (1922), 8 TC 208.

⁸⁰³ (1923) AC 744.

⁸⁰⁴ (1913), 6 T.C. 163.

"A corporation, like an individual, may have more than one place of residence. The place of residence which immediately occurs to mind as presumably its place of residence is the place of incorporation: That has been spoken of in some of the cases as the place of its birth, it is the place of its birth, but it is more than that, it is the place whose laws may determine its status, it is according to the law of that place that it is a corporation; and therefore it is not only its birth but its status which depends upon the place in which its incorporation takes place, and it would be difficult, I think, to hold under any circumstances the place of its incorporation may not, for some purpose at any rate, as for instance with regard to jurisdiction, be always the place of residence."

In *Bullock v. The Unit Construction Co. Ltd.*, the company which was resident in the United Kingdom formed three companies in Kenya. Each subsidiary company had its registered office in Kenya and carried on its business there. Under their articles, their management and control of business were handled by their directors. Their meetings were in Kenya and none of the directors was a director of parent company.

After the lack of success of the subsidiaries, the parent company decided to take over their management and control. The companies' senior representative in Kenya had been told and he accepted that. Subsequently all decisions about the companies were made by the parent company; the Kenyan directors never met again and they did not have access to all the documents and information.

The respondent company which was another wholly-owned subsidiary of the parent company and was resident in the United Kingdom, made certain payments to the three African subsidiaries. If, as it was claimed each of the Kenyan subsidiaries was resident in the United Kingdom, then the company was entitled to deduct the payments in computing its profits.

The commissioners said that real control and management was in London and so the three subsidiary companies were resident in the United Kingdom. The High Court and the Court of Appeal had held that authorised and constitutional management and control was more important than real control and management, but this was reversed by the House of Lords. The latter found the Commissioner's decision was

correct in that actual control is more important in determining company's residence than legal control⁸⁰⁵.

In *Attorney-General v. Alexander*⁸⁰⁶, the Imperial Ottoman Bank was a company incorporated in Constantinople, but carrying on business through a branch in London. The Court decided that the company was not resident in the United Kingdom, not because of the company's incorporation, but because it had its "seat" in Constantinople. "Seat" is used by Viscount Sumner in *Egyptian Delta Land and Investment Co. Ltd. v. Todd*⁸⁰⁷, as meaning "not...its place of corporation, but its chief place of business."

Baron Amplett stated in *Attorney-General v. Alexander* that:

"...if an individual cannot be said to reside wherever he carries on business, how can a foreign corporation be said to reside within the United Kingdom for no other reason than it carries on business there? It must follow the same rule."

Huddleston B. also pointed out in *Cesena Sulphur Company Limited v. Nicholson*⁸⁰⁸ that the residence of the company is where the place they really carry on business:

"...You do not find any great difficulty in defining the residence of an individual; it is where he sleeps and lives. We understand perfectly well the residence of a natural person.

Then what is the residence of this artificial person? ...the residence of this artificial person, like a trading corporation, must be considered to be where he carries on its business, where the real trade or business is carried on...it does not mean the place where they carry on the form and shadow of a business, but means the place where they really carry on the business."

⁸⁰⁵ (1959), 38 T.C. 712.

⁸⁰⁶ (1874) LR 10 Exch 20.

⁸⁰⁷ (1929) A.C. 1.

⁸⁰⁸ (1876), 1 T.C. 89.

In *Swedish Central Railway Company Limited v. Thompson*⁸⁰⁹, Viscount Cave L.C. expressed that a company may have more than one residence since the central management and control of a company may be divided.

In the same case Viscount Cave thinks that the registration in the United Kingdom by itself may not be appropriate to establish that a company has a residence in the United Kingdom. The place of registration is to be considered with other circumstances. The same point is also expressed in *Todd v. Egyptian Delta Land and Investment Company Limited*⁸¹⁰.

Also, in *James Wingate and Co. v. Webber*⁸¹¹, the Court found that a shipping company incorporated in Norway and not resident in the United Kingdom. However, in *Goerz & Co. v. Bell*⁸¹², despite the fact that the company was incorporated in South Africa, the Court found that it was resident in the United Kingdom.

In *New Zealand Shipping Company Limited v. Stephens*⁸¹³, although the company had New Zealand directorate and a London directorate, the court held that the company was resident in the United Kingdom, because all important decisions for the company were made in London.

In *Denver Hotel Co. v. Andrews*⁸¹⁴ a United Kingdom incorporated company had an hotel abroad. The court found that the centre of the business was in the United Kingdom because, the directors' meetings were in the United Kingdom and the hotel manager was receiving orders from directors. Also the accounts was in the United Kingdom.

In *Aramayo Franche Mines Ltd. v. Eccott*⁸¹⁵ the court held that despite the existence of local board abroad, the business was controlled from London. The same result was reached in *London Bank of Mexico and South America v. Apthorpe*⁸¹⁶, because, the directors

⁸⁰⁹ (1925), 9 T.C. 342.

⁸¹⁰ (1928), 14 T.C. 119.

⁸¹¹ (1897), 3 TC 569.

⁸¹² (1904), 2 KB 136.

⁸¹³ (1907), 5 T.C. 553.

⁸¹⁴ (1895), 3 T.C. 356.

⁸¹⁵ (1925), 9 T.C. 445.

⁸¹⁶ (1891), 3 T.C. 143.

were meeting and managing the company from London. Some other examples can be given with the same conclusion such as *Grove v. Elliots and Parkinson*⁸¹⁷ and *San Paulo (Brazilian) Railway Company v. Carter*⁸¹⁸.

As Lord Radcliffe expressed the view in *Unit Construction Co. Ltd. v. Bullock*⁸¹⁹ that a statutory definition would have been provided.

The United Kingdom Inland Revenue published a Consultative Document⁸²⁰ on company residence in 1981⁸²¹. The document also pointed out the need for a proper definition as follows:

"1- It has become apparent that consideration needs to be given to the concept of company residence for tax purposes. There is no general statutory definition, and the meaning of the term derives from case law which is mostly of some antiquity. The courts have equated "residence" with the place of central management and control. In deciding where that is, considerable weight has been given to the place where formal meetings of directors are held, but the value of that test is today brought into question by instant communication, by rapid and easy transport and by changes in the ways in which companies decide on and implement policy.

2- The established criteria have not only become artificial with the passage of time and technical innovation, they also have enabled companies to arrange a residence for tax purposes which may bear little relation to the seat of the company's operations. There is also a degree of uncertainty about the law which is undesirable for companies and advisers as well as for the Revenue... "

⁸¹⁷ (1896), 3 T.C. 481.

⁸¹⁸ (1896), 3 T.C. 407.

⁸¹⁹ (1959) 38 T.C. 712.

⁸²⁰ The United Kingdom IRS: "Company Residence: A Consultative Document-26.6.1981", *European Taxation*, 1981, pp.60-61.

⁸²¹ See, in general, Malcolm J. Gammie, "Company Residence: All Change?", *Taxation*, 20.2.1982, pp.583-588.

The Institute of Taxation was strongly against the incorporation rule, that any company incorporated in the United Kingdom will be subject to United Kingdom tax on its worldwide income. They thought that it was not necessary and that the present law was adequate concerning residence⁸²². However, the application of case law could be difficult because of the existence of so many cases. Also the Consultative Committee of Accountancy Bodies stated that, the definition of residence may be helpful but the test of "central management and control" must remain⁸²³.

The Institute of Taxation said that, to find the true meaning of the term "central management and control" is quite important within the concept of extensive business relations and the location of directors' meetings is not appropriate to determine the central management and control of the company⁸²⁴.

However, the Law Society's Standing Committee offered three possible tests for the company residence:

- 1- a place of incorporation test
- 2- a place of central management and control test
- 3- a "multi-factor" test⁸²⁵.

After they considered on these three tests they strongly preferred the "central management and control" test. The incorporation test is inflexible and may discourage international trade. The "multi-factor" test is impractical since requires examination of each factor linking a company with the United Kingdom and could lead to litigation⁸²⁶. They stated that:

"Lawyers and accountants and possibly the Inland Revenue have in recent years tended to attach too much importance to the place where board meetings are held in determining residence, and that if the test of central management and control were to be properly applied - by ascertaining where as a general rule the principal policy decisions

⁸²² The Institute of Taxation: "Comments on a Consultative Document", *European Taxation*, 1981, pp.243-245 (Hereinafter referred as Comments).

⁸²³ News Digest, *Taxation*, 11.7.1981, p.399.

⁸²⁴ Comments, op. cit., pp.243-245.

⁸²⁵ News Digest, *Taxation*, 15.8.1981, p.352.

⁸²⁶ Idem.

affecting a company's business are taken - the scope for manipulation would be substantially reduced."

Although its effort is considered inadequate⁸²⁷, the Institute of Fiscal Studies also made comment on the Inland Revenues Consultative Document. They supported the "effective management" test. They said that it is an intermediate management level between "strategic management" (the making policy) and "junior and shop floor management" (supervision of day-to-day operations)⁸²⁸.

In this context, the residence of the company is the place where policy decisions are made. However, the priority between the "effective management" test and the "central management and control" test is not clear since they offered some other criteria that can apply in certain cases, such as the situs and number of board meetings, the nature and materiality of the business done there and the residence and executive responsibilities of the directors applied⁸²⁹.

Also some other documents have been published about company residence in the United Kingdom by the Inland Revenue. The first one is "International Tax Avoidance" in November 1981 and the second one is "Taxation of International Business" in December 1982. In the latter it has been explained that the proposal to define company residence had been abandoned⁸³⁰ and the "central management and control" test is retained. They stated that:

"The Government remain of the view that the existing "central management and control" test does not produce satisfactory results in all present-day circumstances. Nonetheless they are conscious of the widespread unease produced amongst the business community by the original proposal to replace the existing case law concept with a statutory definition at this stage...The Inland Revenue will issue a Statement of Practice which will clarify the application of the present test of company residence."

⁸²⁷ Malcolm J. Gammie, "International Tax Avoidance-Progress at Last?", *Taxation*, 23.10.1982, p.90.

⁸²⁸ *Idem*.

⁸²⁹ *Idem*.

⁸³⁰ ---, "Taxation of International Business", *Taxation*, 1.1.1983, p.356; Also see, Malcolm J. Gammie, "The Taxation of International Business-I", *Taxation*, 12.2.1983, pp.532-535; Roy Parker, "Company Residence", *Taxation*, 27.11.1987, pp.191-192.

Later, the Inland Revenue issued a Statement of Practice to explain their opinion on the application of the "central management and control" test⁸³¹.

After all the speculation about company residence, in 1988 the incorporation rule was introduced in the 1988 Budget and by Section 66 of the Finance Act 1988⁸³² as follows:

*"Subject to the provisions of Schedule 7 to this Act, a company which is incorporated in the United Kingdom shall be regarded for the purposes of the Taxes Acts as resident there; and accordingly, if a different place of residence is given by any rule of law, that place shall no longer be taken into account for those purposes."*⁸³³

The last sentence seems confusing since, for example, the place of effective management can be given as a residence of the company in a double taxation agreement. However, the incorporation rule determines residence under the United Kingdom domestic law and the place of effective management rule here serves for the purpose of double taxation agreements. For this reason the incorporation rule does not override the provisions of double taxation treaties⁸³⁴.

The existence of dual residence under national law was first mentioned in *Goerz & Co. v. Bell*⁸³⁵. After that in *De Beers Consolidated Mines Ltd. v. Howe*⁸³⁶ and *American Thread Co. v. Joyce*⁸³⁷ the possibility of dual residence is mentioned without any solution, and in 1915, the issue was subject to examination in *Mitchell v. Egyptian Hotels Ltd.*⁸³⁸.

Although it has been stated that the company is resident in the United Kingdom since it is registered in the United Kingdom and the board of directors was in the United Kingdom, it was decided that the company is managed and controlled in Egypt by the board of local directors. Lord Parker stated that:

⁸³¹ SP 6/83, 27.7.1983.

⁸³² *Supra*, p.200.

⁸³³ FA 1988, Section 66(1).

⁸³⁴ SP 1/90, 9.1.1990, para.23.

⁸³⁵ (1904) 2 K.B. 136.

⁸³⁶ (1906) A.C. 455.

⁸³⁷ (1913) 6 T.C. 163.

⁸³⁸ (1915) A.C. 1022.

"...It may well be possible that the board of directors of the company still retain powers by virtue of which they could, if occasion arises, so interfere with the company's business in Egypt that such business would cease to be carried on wholly outside this country, but, as I have already pointed out, it is not what they have power to do, but what they have actually done, which is of importance for determining the question which now arises for decision. In the absence of any act done or directed by any person resident here in participation or furtherance of the business operations in Egypt from which the profits and gains in question arose, I think...this trade or business was carried on wholly outside the United Kingdom..."

Dual residence was found to exist in *Swedish Central Railway Company Limited v. Thompson*⁸³⁹, *Egyptian Delta Land and Investment Company Limited v. Todd*⁸⁴⁰ and *Union Corporation Limited v. I.R.C.*⁸⁴¹.

In *Swedish Central Railway Company Limited v. Thompson*, the company was registered in the United Kingdom. They received rent from the railway-line between Frovi and Ludrika in Sweden. After the *De Beers* case, the company decided to move its board meetings, and its decision making power, to Stockholm in Sweden in order to establish central management and control there. But the Secretary, the company seal, and the company's bank account remained in London where also the three directors and the secretary periodically met.

The House of Lords decided that dual residence was possible in law. Viscount Cave LC stated in *Swedish Central Railway* that:

"...in my opinion a registered company can have more than one residence for the purposes of the Income Tax Acts. It has often been pointed out that a company cannot in the ordinary sense 'reside' anywhere, and that in applying the conception of residence to a company it is necessary (as Lord Loreburn said in the *De Beers* case) to proceed as nearly as possible upon the analogy of an

⁸³⁹ (1925) A.C. 495.

⁸⁴⁰ (1929) A.C. 1.

⁸⁴¹ (1951), 34 T.C. 207.

individual...when the central management and control of a company abides in a particular place the company is held for the purposes of income tax to have a residence in that place; but it does not follow that it cannot have a residence elsewhere.

An individual may clearly have more than one residence; and in principle there appears to be no reason why a company should not be in the same position. The central management functions may be divided and it may 'keep house and do business' in more than one residence."

In the second case, the Egyptian Delta Land and Investment Company Limited, incorporated in the United Kingdom, transferred the whole of its business to Egypt. The Commissioner found that the company was non-resident. The House of Lords confirmed it. Viscount Sumner compared the case with *Swedish Central Railway* case and stated that:

"All that was decided in the Swedish Central Railway case was that the company could have two residences, one in England as well as one in Sweden. Your Lordships were not asked to decide more. It is true that by admission the controlling power over the business was in Sweden, but other business was done in London, the character and importance of which, though set out in the Case, was not discussed at the Bar.

It was a matter of degree on the facts and your Lordships cannot be deemed to have come to some unexpressed conclusion on that ground merely because you did not for yourselves declare...that there was no evidence of business carried on in England...Nor is it decisive of the point to say now that the business done in England was only administrative. It was in fact a good deal more, and in the static condition of the company's affairs it was not much less important than the Swedish part. If new questions arose the Swedish directors could settle them, but as things were little had to be done anywhere except 'administration'...and that was fairly divided between the two countries."

This was the first case in which the Court found a United Kingdom registered company to be non-resident⁸⁴².

The main difference between the two cases is that in the first, the company did not remove all its functions to Sweden and left a bank account, a company seal and its secretary in England, making it difficult to say that it has no residence in the United Kingdom. In the other case, however, the business was run wholly in Egypt and because of this the company was considered resident in Egypt.

In the third case, *Union Corporation Limited v. I.R.C.*⁸⁴³, the company was registered in South Africa. The ultimate control was in London, but some members of the board were meeting in South Africa. The Court decided that the company had dual residence despite the fact that ultimate control was in London.

*Koitaki Para Rubber Estates Ltd. v. Federal Court of Taxation*⁸⁴⁴ was an Australian case on which Sir Raymond Evershed MR built his decision⁸⁴⁵ on *Union Corporation Ltd. v. I.R.C.* In this Australian case Dixon J. stated that:

"...a finding that a company is a resident of more than one country ought not to be made unless that control of the general affairs of the company is not centred in one country but is divided or distributed among two or more countries.

The matter must always be one of degree and residence may be constituted by a combination of various factors, but one factor to be

⁸⁴² John F. Avery Jones: "Domicile and Residence in the United Kingdom", *European Taxation*, 1981, p.176.

⁸⁴³ (1951) 34 T.C. 207.

⁸⁴⁴ (1940), 64 C.L.R. 15.

⁸⁴⁵ Denzil Davies, *Booth: Residence, Domicile and United Kingdom Taxation*, Butterworths, Edinburgh-1995, p.161; Denis Sheridan, "The Residence of Companies for Taxation Purposes", *British Tax Review*, 1990, pp.104-105.

looked for is the existence in the place claimed as a residence of some part of the superior or directing authority by means of which the affairs of the company are controlled."

In the light of the case mentioned above, in *Union Corp. Ltd v. I.R.C*⁸⁴⁶, the Commissioners found that the company was resident in the United Kingdom, but this was rejected by the Court of Appeal. The company was incorporated in South Africa. Although the management and control was divided between the United Kingdom and South Africa, the directors' decision in London was final and supreme. Sir Raymond Evershed MR concluded that there must be some part of the superior and directing authority with some substantial business operations for the existence of residency.

In *Bullock v. The Unit Construction Co. Ltd.*⁸⁴⁷, Lord Radcliffe expressed his view about dual residency with the following:

"...Few people can feel that there is an close analogy between the residence imputed to an individual. While it is not difficult to see that the circumstances that make an individual 'resident' may reproduce themselves for him at one and the same time in more than one country, it is much harder, when a company is concerned, to feel satisfied that two quite different tests, depending upon different sets of circumstances, can each be applied concurrently for the purpose of determining residence.

For any one taxing authority the relevant question is whether the company is resident within the area of its jurisdiction or non-resident: it is not required to ascertain positively whether or not the company is also resident within another jurisdiction. If the accepted test is that a company is resident in that country where its central management and

⁸⁴⁶ (1951) 34 T.C. 207.

⁸⁴⁷ (1959) 38. T.C. 712.

control do not abide in England, it seems that in such cases the nature of the test itself precludes the conclusion that the company is nevertheless resident here."

5- International Transportation Income

In *Income Tax Case No.1048*⁸⁴⁸, between United Kingdom and Rhodesia, the Court⁸⁴⁹ found that commission income from arranging connection of sea passages for air passengers is not within the context of profits from operating aircraft. The air transportation company was registered in the United Kingdom, but carried on business in Rhodesia.

The company arranged for the sea passage of its passengers because some part of the journey was by air and some part was by sea. The company charged a 7% commission for the sea part of the journey and claimed that this income was exempted from income tax under 1955 Rhodesia and Nyasaland - United Kingdom tax treaty.

Article V of the treaty states that: "...profits which a resident of one of the territories derives from operating ships (other than ships operated wholly on inland waters) or aircraft shall be exempt from tax in the other territory."

After the appeal, H.E. Davies Q.C. found that:

"...where such other activities are entirely incidental to the carrying on of the business of operating aircraft the proceeds of such other business can properly be regarded as the proceeds of the business of operating aircraft...appellant only undertakes the arrangement of sea passages for its own passengers and as a convenience to its own passengers...the small amounts received from the Union-Castle Company during the two years in question can properly be regarded as received by appellant in the course of its business of operating aircraft. I consider that they are exempt from tax in terms of Article V of the Double Taxation Avoidance Agreement."

⁸⁴⁸ 19.5.1964, 26 SATC 226 in *Edwardes-Ker*, op. cit., pp.6-7 of Article 8.

⁸⁴⁹ Federation of Rhodesia and Nyasaland Special Court.

As an example, the French Court decided that, a hotel bar/restaurant and tax free shop were not included with the operation of a hovercraft line⁸⁵⁰.

In the United Kingdom, despite the following cases are related to VAT, some examples can be given about income from transportation activities.

In *Virgin Atlantic Airways Limited v. The Commissioner of Customs and Excise*⁸⁵¹, the appellant was Virgin Atlantic Airways Limited against the decision of the VAT Tribunal who decided that VAT was chargeable on a variety of transfer options to and from the airport. In the United Kingdom, the airlines were offering limousine services, included in the ticket price, to passengers paying more than the economy fare from their homes to the airport.

The High Court stated that the passenger had paid one indivisible and irreducible price for the journey; and whether the supply of, for example, a limousine on request was an integral part of the supply of the flight when no extra charge was payable, should be considered on a common sense basis -- it would be unrealistic to split the provision of the limousine's service from the flight itself and find two separate suppliers⁸⁵².

In *Customs and Excise Commissioners v. Peninsular and Oriental Steam Navigation Co. Ltd.*⁸⁵³, the problem was whether cruise ticket price which includes food, accommodation, entertainment and transport is subject to Value Added Tax at the standard rate.

The company claims that the price includes all those activities and these were therefore zero-rated. However, the commissioners claimed that the supply of a cruise was a multiple supply of services and, even if it was a single supply, it was a holiday cruise rather than passenger transport and subject to standard rate. The Tribunal found that it was a single supply of services and it was a passenger transport, therefore the income was subject to zero-rating. The Appeal Court approved the decision.

⁸⁵⁰ Klaus Vogel, *Double Taxation Conventions - Supplement 1994*, Kluwer, Deventer-1994, p.49.

⁸⁵¹ (1993) V.A.T.T.R. 136.

⁸⁵² (1993) V.A.T.T.R. 136.

⁸⁵³ (1996) S.T.C. 698.

Also, in *British Airways plc. v. The Commissioners of Custom and Excise* the Court decided in two separate cases in 1977 and 1989⁸⁵⁴ that the provision of on-flight catering was also an integral part of the provisions of air transport.

In 1977 decision Stuart-Smith L.J. stated that: "British Airways do not just supply transportation, they supply transportation to a certain degree of comfort". In 1989 decision Otton J. stated that: "...In substance and reality catering was an integral part of the transport or an integrant of the transport or a component of the transport...the answer is one of common sense...It seems to me that the providing of in-flight catering is an adjunct to the facility of transport..."

The Commissioners were claiming that there existed two separate supplies, transportation and catering and the income from catering was subject to Value Added Tax⁸⁵⁵. However, the Commissioners' appeal was dismissed by the Court of Appeal.

6- Carrying on trade or business

It is difficult to find principles about carrying on trade or business since the existence of extensive activities to make money. When a corporation make transactions, it is within the concept of business since the company is formed to carry on business as expressed in *Smith v. Anderson*⁸⁵⁶. In the same case Brett, L. J. stated that: "...The expression "carrying on" implies a repetition of acts, and excludes the case of an association formed for doing one particular act which is never to be repeated. That series of acts is to be a series of acts which constitute a business..."

Despite the continuity being an important element in carrying on trade, in *Martin v. Lowry*⁸⁵⁷, it has been found that sometimes only one purchase is sufficient for a trade.

⁸⁵⁴ (1977) 2 All E.R. 873; (1989) S.T.C. 182.

⁸⁵⁵ (1990) S.T.C. 643.

⁸⁵⁶ (1880), 15 Ch.D.147.

⁸⁵⁷ (1925), 11 T.C. 297.

In *St. Aubyn Estates v. Strick*⁸⁵⁸, for Finlay J. the term "business" has been used "...as a convenient way of expressing a trade, manufacture, adventure or concern in the nature of trade...". A similar explanation has been made in *Pickford v. Quirke*⁸⁵⁹ by Lord Hanworth.

The term "trade" must include not only manufacture but also the selling as stated in *Guest, Keen & Nettlefold's Limited v. Fowler*⁸⁶⁰.

In *Commissioners of Inland Revenue v. Marine Steam Turbine Company Ltd.*⁸⁶¹, Rowlatt J. expressed the meaning of the term "business" in a very wide and elastic form-but then restricts the meaning, as follows:

"...it has two distinct meanings. It may mean any particular matter or affair of serious importance. The question here is whether there was a business carried on, not merely whether there was a business involved in what these people were doing..The word 'business' however is also used in another and very different sense, as meaning an active occupation or profession continuously carried on, and it is in this sense that the word is used ..."

In terms of difficulties to express whether an incident constituted carrying on business in practice Sir George Jessel prefers the expression "it is a compound of fact made up of a variety of incidents" in *H.G.Erichson v. W.H.Last*⁸⁶². In the same case, for Cotton L.J. a person is carrying on a trade or business when a person habitually does same thing to produce a profit such as enters into a contract.

⁸⁵⁸ (1932), 17 T.C. 412.

⁸⁵⁹ (1927) 13 T.C. 269.

⁸⁶⁰ (1910), 5 T.C. 511.

⁸⁶¹ (1919), 12 T.C. 174.

⁸⁶² (1881), 4 T.C. 422.

The expression made by Sir George Jessel, is also mentioned in *Werle & Company v. Colquhoun*⁸⁶³, *Grainger & Son v. W. L. Gough*⁸⁶⁴ and *Spiers and Son Limited v. Ogden*⁸⁶⁵.

Scrutton L.J. expressed in *Belfour v. Mace*⁸⁶⁶ that if a contract is made abroad the foreign person is not exercising a trade in the United Kingdom. At that point, the communication between a foreign person and a United Kingdom person is considered as a connection point to deem the foreign company to be carrying on business in the United Kingdom.

Also, the existence of an agent in the United Kingdom is an indication that foreign person is carrying on business as expressed in *H.G. Erichsen v. W.H. Last*⁸⁶⁷, *Werle & Co. v. Colquhoun*⁸⁶⁸, *Pommery and Greno v. Apthorpe*⁸⁶⁹ and *Firestone Tyre and Rubber Co. Ltd. v. Lewellin*⁸⁷⁰.

Lord Esher M.R. stated in *Werle & Co. v. Colquhoun* that:

"I cannot help thinking that the profits may be received abroad from a trade, which trade is carried on in England and yet cannot the less be said to be profits the result of a trade which is carried on here. If the profits are received in England, that is a very strong circumstance. If there is an establishment in England, that is a very strong circumstance; but neither of them is essential."

⁸⁶³ (1888), 2 T.C. 402.

⁸⁶⁴ (1896), 3 T.C. 462.

⁸⁶⁵ (1932), 17 T.C. 117.

⁸⁶⁶ (1928), 13 T.C. 539.

⁸⁶⁷ (1881), 4 T.C. 422.

⁸⁶⁸ (1888), 2 T.C. 402.

⁸⁶⁹ (1886), 2 T.C. 182.

⁸⁷⁰ (1957), 37 T.C. 111.

When a United Kingdom agent communicates an acceptance to the other person who made an offer, the contract is made in the United Kingdom. Furthermore, when a United Kingdom agent accepts the orders on behalf of a foreign person, the contract is made in the United Kingdom. Under these circumstances, the foreign person is carrying on a trade or business in the United Kingdom as expressed in *Belfour v. Mace*⁸⁷¹, *E. and P. Gavazzini v. Mace*⁸⁷², *Turner (Thomas) Ltd. v. Rickman*⁸⁷³ and *Wilcock v. Pinto & Co.*⁸⁷⁴.

For the existence of "trade" there must be at least two parties as stated in *Dublin Corporation v. Mc Adam*⁸⁷⁵. In this situation buying itself without selling in the United Kingdom does not constitute trading within the United Kingdom as expressed in *Grainger & Son v. W.L. Gough*⁸⁷⁶.

To find whether a trade or business is carried on, the facts of the business must be looked at, as expressed in *C.I.R. v. Budderpore Oil Company*⁸⁷⁷, *Collins v. Firth-Brearley Stainless Steel Syndicate Limited*⁸⁷⁸ and *Wilcock v. Pinto & Company*⁸⁷⁹.

To make a contract in the United Kingdom is a vital element in carrying on trade or business in the United Kingdom. In this context, many examples can be given such as, *Crookston Brothers v. Furtado*⁸⁸⁰, *Eccott v. MacLaine and Company*⁸⁸¹, *Lethem v. W.H. Muller*

⁸⁷¹ (1928), 13 T.C. 539.

⁸⁷² (1926), 10 T.C. 698.

⁸⁷³ (1898), 4 T.C. 25.

⁸⁷⁴ (1925), 9 T.C. 111.

⁸⁷⁵ (1887), 2 T.C. 387.

⁸⁷⁶ (1896), 3 T.C. 462.

⁸⁷⁷ (1921), 12 T.C. 467.

⁸⁷⁸ (1925), 9 T.C. 520.

⁸⁷⁹ (1924), 9 T.C. 111.

⁸⁸⁰ (1910), 5 T.C. 602.

⁸⁸¹ (1926), 10 T.C. 481.

and Company (London) Limited⁸⁸², *Nielsen, Andersen and Company v. Collins*⁸⁸³ and *E. and P. Gavazzi v. Mace*⁸⁸⁴.

In *Eccott v. MacLaine and Company*⁸⁸⁵ it has been stated that the important point is whether a contract is made within the country and this is much more important than the place of delivery and payment. However, despite the fact that making a contract indicates that a trade or business is carried on, making a contract somewhere else does not indicate that a trade or business is not carried on.

If the contract is made abroad but delivery is made in the United Kingdom, a company is carrying on trade in the United Kingdom as expressed in *Thomas Turner (Leicester) Limited v. Rickman*⁸⁸⁶.

Atkin L. J. said in *F. L. Smidth & Co. v. Greenwood*⁸⁸⁷ that:

"...it is sufficient to consider only where it is that the sale contracts are made which result in a profit. It is obviously a very important element in the enquiry, and, if it is the only element, the assessments are clearly bad. The contracts in this case were made abroad. But I am not prepared to hold that this test is decisive. I can imagine cases where the contract of re-sale is made abroad, and yet the manufacture of the goods, some negotiation of the terms, and complete execution of the contract take place here under such circumstances that the trade was in truth exercised here. I think that the question is, where do the operations take place from which the profits in substance arise?"

It has been expressed that to accept an offer made by the other party is an indication of a contract between two parties. In this context, some other points may be of some importance such as the place of payment, work and delivery.

⁸⁸² (1927), 13 T.C. 126.

⁸⁸³ (1927), 13 T.C. 91.

⁸⁸⁴ (1926), 10 T.C. 698.

⁸⁸⁵ (1926), 10 T.C. 481.

⁸⁸⁶ (1898), 4 T.C. 698.

⁸⁸⁷ (1922), 8 T.C. 193.

A similar comment was made in *Crookston Brothers v. Furtado*⁸⁸⁸:

"Viewing the matter in the light of authority, I consider that the following propositions may be deduced from the numerous cases which have been decided. In the first place, if contracts are concluded by or on behalf of a foreigner, and the goods delivered and payments made, all within the United Kingdom it seems clear that the foreigner will be held to exercise a trade in this country. Next, I think the result will be the same if the contracts are concluded and the deliveries made in this country, though the payments are received abroad,...Lastly,...if the contracts are concluded in this country that fact alone will be sufficient to constitute an exercise of trade here."

Also, it has been found that the foreign person was carrying on trade or business within the United Kingdom in *Wingate (James) & Co. v. Webber*⁸⁸⁹, *Tarn v. Scanlan*⁸⁹⁰, *Nielsen, Andersen & Co. v. Collins*⁸⁹¹ and *Muller (WH) & Co. (London) Ltd. v. Lethem*⁸⁹².

Although the distinction between the terms "with" and "within" the country looks obvious, it is explained in *Grainger & Son v. William Lane Gough*⁸⁹³, by Lord Herschell:

"...I think there is a broad distinction between trading *with* a country and carrying on a trade *within* the country. Many merchants and manufacturers export their goods to all parts of the world, yet I do not suppose any one would dream of saying that they exercise or carry on their trade in every country in which their goods find customers...something more must be necessary in order to constitute the exercise of a trade *within* this country...If all that a merchant does in any particular country is to solicit orders, I do not think he can reasonably be said to exercise or carry on his trade in that country..."

⁸⁸⁸ (1910), 5 T.C. 602.

⁸⁸⁹ (1897), 3 T.C. 569.

⁸⁹⁰ (1928), 13 T.C. 91.

⁸⁹¹ (1928), 13 T.C. 126.

⁸⁹² (1957), 37 T.C. 505.

⁸⁹³ (1896) A.C. 325.

The importance of the term "where the trade is carried on" is expressed in two ways by Lord Chancellor in *San Paulo v. Carter*⁸⁹⁴.

"... It may mean where the goods in respect of which trading is carried on are conveyed, made, bought or sold; or speaking of land, where it is cultivated or used for any other purposes of profit. That makes the locality of the goods or the land which are the subject of the trade, to be in a certain sense the place where the trade is carried on because it is the place where the things corporeally exist or are dealt with. But there is another sense in which the conduct and management, the head and brain of a trading adventure are situated at a place different from that in which the corporeal subjects of trading are to be found. It becomes therefore a question of fact, and according to the answer to be given to the question 'where is the trade in a strict sense carried on?', will the answer be, under the Income Tax Acts, there it is liable to assesment."

In *Watson v. Sandie & Hull*⁸⁹⁵, to determine the carrying on of business, the goods belonging to the non-resident must be physically present in the country and sales must be made. Also, the person dealing with the goods must be the non-resident's agent.

7- Taxation of non-resident companies

In the United Kingdom there is no special provisions for international transportation companies such as the other sample countries under the tax acts. Foreign transportation companies will be subject to tax as any other foreign company.

A company not resident in the United Kingdom is not subject to corporation tax unless it carries on a trade in the United Kingdom through a branch or agency but, if it does so, it is subject to corporation tax on all its chargeable profits wherever arising⁸⁹⁶.

⁸⁹⁴ (1896) A.C. 31.

⁸⁹⁵ (1898), 1 Q.B. 326.

Section 11(2) of Income and Corporation Tax Act 1988 states that:

"For the purposes of corporation tax the chargeable profits of a company not resident in the United Kingdom but carrying on a trade there through a branch or agency shall be -

(a) any trading income arising directly or indirectly through or from the branch or agency, and any income from property or rights used by, or held by or for, the branch or agency (but so that this paragraph shall not include introductions received from companies resident in the United Kingdom); and

(b) such chargeable gains as are, by virtue of section 10(3) of the 1992 Act, to be, or be included in, the company's chargeable profits."

If a non-resident person has a trade or business in the United Kingdom but not a branch or agency, he is not subject to tax under Section 11(2). In this context, the related section in ICTA 1988 is Section 18, Schedule D for the foreign transportation companies. Case I under Schedule D is related to tax in respect of any trade carried on in the United Kingdom⁸⁹⁷. Carrying on trade is an important factor to determine whether an international transportation company will be subject to tax in the United Kingdom.

Schedule D in Section 18 states that:

"(1) The Schedule referred to as Schedule D is as follows:-

Tax under this Schedule shall be charged in respect of-

(a) the annual profits or gains arising or accruing-

...

⁸⁹⁶ ICTA 1988, s.11(1).

⁸⁹⁷ ICTA 1988, Section 18(3).

(iii) to any person, whether a Commonwealth citizen or not, although not resident in the United Kingdom from any property whatever in the United Kingdom or from any trade, profession or vocation exercised within the United Kingdom, and

...

(2) Tax under Schedule D shall be charged under the cases set out in subsection (3) below, and subject to and in accordance with the provisions of the Tax Acts applicable to those Cases respectively.

(3) The Cases are -

Case I:

tax in respect of any trade carried on in the United Kingdom or elsewhere;

..."

Also, Section 6(2) of the ICTA 1988 states that:

"The provisions of the Income Tax Acts relating to the charge of income tax shall not apply to income of a company (not arising to it in a fiduciary or representative capacity) if -

(a) the company is resident in the United Kingdom, or

(b) the income is, in the case of a company not so resident, within the chargeable profits of a company as defined for the purposes of corporation tax by section 11(2)."

If foreign person has an agent in the United Kingdom, he is trading within the United Kingdom. It is possible for companies to carry on a trade in the United Kingdom without a branch or agency. In this case the company must pay income tax on

its profits⁸⁹⁸. However, the United Kingdom Revenue may have problems of tax collection in the absence of any United Kingdom presence⁸⁹⁹.

Also, Section 18(5) states that, Part IV contains further provisions relating to the charge to tax under Schedule D. In this context the related sections are 60-64 of the ICTA 1988.

⁸⁹⁸ See, ICTA 1988, Section 6(2).

⁸⁹⁹ Whitehouse, *op. cit.*, p.538.

CHAPTER VIII: THE UNITED STATES

1- Introduction

In order to avoid multiple taxation tax exemptions have been granted and have existed in the United States since 1921.

Three types of reciprocal exemption exist in the United States⁹⁰⁰:

- By treaty⁹⁰¹ (both by income tax treaties and transportation agreements⁹⁰²)
- By letter of understanding⁹⁰³
- Unilaterally⁹⁰⁴.

Under the United States tax system, a United States corporation is subject to regular federal corporate tax at the following rates⁹⁰⁵. Income up to \$50,000 is subject to

⁹⁰⁰ The Revenue Ruling 89-12, 1989-1 C.B. 234; Garrison, *op. cit.*, p.155; Outtersson-Cheung, *op. cit.*, p.592.

⁹⁰¹ Australia, Austria, Barbados, Belgium, Canada, China (P.R.C.), Cyprus, Denmark, Egypt, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Italy, Jamaica, Japan, Republic of Korea, Luxembourg, Malta, Morocco, the Netherlands, New Zealand, Norway, Pakistan (aircraft only), Poland, Romania, the Soviet Union, Sweden, Switzerland, Trinidad and Tobago and the United Kingdom. At the same time the United States have transportation agreements with some of the above countries, such as, Belgium, Cyprus, Denmark, Finland, Greece and Sweden.

⁹⁰² *Infra.*, p.231.

⁹⁰³ After 1.1.1987, new agreements were concluded with Argentina, the Bahamas, Denmark, Liberia, Panama, Sweden and Venezuela. All agreements before 1.1.1987 cancelled after the amendments to section 883.

⁹⁰⁴ The Bahamas, Bermuda, Brazil, Bulgaria, the Cayman Islands, Chile, Liberia, the Netherlands, the Netherlands Antilles, Portugal, Spain, Vanuatu and the United States Virgin Islands do not tax income from the operation of ships and aircraft. From 1.1.1987, Turkey also exempts United States persons' transportation incomes derived from Turkish sources.

⁹⁰⁵ IRC, Section 11.

tax at a rate of 15 per cent, income between \$50,000 and \$75,000 is subject to tax at a rate of 25 per cent. In excess of 75,000 34 per cent⁹⁰⁶ and income in excess of 10,000,000 35 per cent.

A corporation which is incorporated in the United States or under the law of United States or any state⁹⁰⁷, is a United States corporation. Foreign corporations are all corporations other than United States corporations, including corporations incorporated in possessions of the United States, for example the Virgin Islands⁹⁰⁸.

The United States has signed many transportation agreements with other countries after existing agreements have been terminated by the United States unilaterally in terms of the 1986 changes⁹⁰⁹.

1986 was a very important year for the tax system applicable to foreign transportation companies in the United States⁹¹⁰. The Internal Revenue Code of 1986 was enacted by 1986 Tax Reform Act to replace the Internal Revenue Code of 1954, which needed many changes by virtue of the development of international tax law.

The Tax Reform Act 1986 changed the taxation of foreign corporations which operate vessels or aircraft in international traffic⁹¹¹. The main changes in the field of international transportation were as follows⁹¹²:

⁹⁰⁶ 46% prior to 1986 Tax Reform Act.

⁹⁰⁷ IRC Section 7710(a)(4).

⁹⁰⁸ IRC Section 7710 (a)(5); See, Jon E. Bischel - Robert Feinschreiber, *Fundamentals of International Taxation*, Practising Law Enstitute, New York-1985, p.213.

⁹⁰⁹ Andersen, op. cit., p.191.

⁹¹⁰ "Foreign Corporations" are corporations that are created or organised outside the United States and under the laws of a country other than the United States; I.R.C. Sections 7701(a)(4), 7701(a)(5), 1982 (Hereinafter referred to as IRC).

⁹¹¹ The Staff of the Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986 (Blue Book - Public Law, 99-514, 22.10.1986, H.R.3838, 99th Congress), Federal Taxes, Prentice-Hall, 5.11.1987, Bulletin 20 Extra, pp.924-932 (Hereinafter referred as Blue Book); The Tax Reform Bill of 1985 (known as "the House Bill") was first presented by the "House Ways and Means Committee" in December-1985, and was later supplemented by H.R. 3838 (the Tax Reform Bill of 1986) by the Senate Finance Committee in June-1986 (the "Senate Bill"). See for details, Kenneth Klein - Donna Marie

a- The imposition of a 4% gross basis tax.

b- Reciprocal exemption to be based on "residence" instead of flag or documentation of vessel.

c- The imposition of a 50% source rule for transportation which begins or ends in the United States.

I will deal with each of them in Section 3⁹¹³.

2- The United States Double Taxation Treaties

The first international tax treaties concerning double taxation appeared in the United States in the late nineteenth and early twentieth centuries. The United States had

Zerbo: "Federal Income Taxation of Transportation Income - Current and Proposed", *Journal of Maritime Law and Commerce*, Vol.17(1986), No.3, pp.297-326.

⁹¹² The Complete Guide to the Tax Reform Act of 1986, Federal Tax Guide, Prentice-Hall, 18.10.1986, Bulletin No.33, pp.1207-1208; The Subcommittee (on tax treaties) of the Committee on United States Activities of Foreigners and Tax Treaties, Section of Taxation, American Bar Association (Hereinafter referred to as the 'Subcommittee of American Bar Association': "Issues Paper on Technical Corrections to the Tax Reform Act of 1986 Relating to Tax Treaties", *Tax Management International Journal*, No.8, August-1988, pp.348-349 (Members of the Committee are M.J.A. Karlin, D.L. Raish, L. De Vos, J.C. Holberton, R.B. Kelley, E.W. Kvam, T.A. Maier, S.A. Musher, R.B. Williams); Donna Marie Zerbo: "United States Federal Income Tax Consequences to Foreign Corporations Engaged in International Shipping", *Lloyd's Maritime and Commercial Law Quarterly*, 1988, p.235; Doernberg, op. cit., pp.47-48; Jim Fuller: "United States TRA'86: International Effects", *Taxes International*, No.83, September 1986, p.17; Howard J. Levine- Howard Berger: "Changes in U.S. Taxation of Income From Ships and Aircraft", *Canadian Tax Journal*, Vol.34(1986), No.5, pp.1215-1216; Bruce D. Garrison, "U.S. Income Taxation of Foreign Transportation Companies after the Tax Reform Act of 1986", *Taxes*, Vol.66(1988) Part II, p.152; For details of pre-1986 system see, Field - Gordon, op. cit., pp.68-97.

⁹¹³ *Infra.*, p.240.

given unilateral double taxation relief to its citizens and residents by providing a tax credit deduction from 1918⁹¹⁴.

The 1928 models issued in Geneva by the League of Nations served as a framework for the earliest United States tax treaties⁹¹⁵. The first general tax treaty -after certain limited treaties about taxation of shipping profits - was with France on 27.4.1932⁹¹⁶ and concerned income from government service, war pensions, private pensions and annuities, royalties and business profits. The next was concluded with Canada in 1936⁹¹⁷.

The treaty that was signed by the United States with Sweden in 1939⁹¹⁸ for the prevention of double taxation was broader than the United States-France treaty⁹¹⁹. It was the United States' first comprehensive international treaty to prevent or mitigate double taxation of income⁹²⁰. Another treaty was signed in 1939 with France⁹²¹ but was not ratified until the end of the Second World War. The United States signed a general treaty with Canada in 1942 concerning double taxation and administrative co-operation⁹²². Transportation income was taxed on the residence principle as stated in Article V:

"Income which an enterprise of one of the contracting states has from the operation of ships or aircraft registered in that state shall be exempt from taxation in the other contracting state."

⁹¹⁴ Adrian A. Kragen: "Double Income Taxation Treaties: The O.E.C.D. Draft", *California Law Review*, Vol.LII(1964), p.306; Rosenbloom - Langbein, op. cit., p.361; Herrick K. Lidstone: "Double Taxation of Foreign Income? Or an Adventure in International Double Talk?", *Virginia Law Review*, Vol.44(1958), p.922; Vogel, op. cit., p.8; for the history of double taxation in the United States see: Edwin R. A. Seligman, *Essays in Taxation*, Massachusetts-1925, pp.99-125.

⁹¹⁵ Rosenbloom - Langbein, op. cit., p.365.

⁹¹⁶ 49 Stat. 3145, Treaty Series, No: 885.

⁹¹⁷ 56 Stat. 1399, Treaty Series, No: 983.

⁹¹⁸ 54 Stat. 1759, Treaty Series, No:958 (In spite of revision by a 1963 protocol (15 U.S.T. 1824, T.I.A.S. No.5656) it is still in effect and is the oldest United States treaty).

⁹¹⁹ Rosenbloom - Langbein, op. cit., p.374; Kragen, op. cit., p.306.

⁹²⁰ This type of treaty applies to all or most types of income (Baker: 1990, p.10).

⁹²¹ Treaty Series 988. A new treaty signed in 1967 (19 U.S.T. 5280, T.I.A.S., No.6518) and revised by protocols in 1970 (23 U.S.T. 20, T.I.A.S. No.7270) and in 1978 (19 U.S.T. 5280, T.I.A.S. No.9500)

⁹²² 56 Stat. 1399, T.S. No:983. It was substantially revised in 1950 (2 U.S.T. 2235, T.I.A.S. No.2347).

Between 1945 and 1958, the United States signed many Treaties⁹²³. In 1955, the Netherlands treaty was extended to an overseas territory of a treaty partner, the Netherlands Antilles⁹²⁴. In 1957, the Belgian treaty was extended to three Belgian territories that are now Rwanda, Burundi and Zaire⁹²⁵. In 1958, the United Kingdom treaty was extended to 20 overseas territories of the United Kingdom⁹²⁶.

The United States signed further sixteen treaties until publication of the United States Model Treaty in 1976⁹²⁷.

On 18.5.1976, the first United States Model Income Tax Treaty was published by the Treasury Department⁹²⁸. In the next year a revised Model was published⁹²⁹, which the Treasury Department suggested as the starting point for negotiations⁹³⁰. On 16 June 1981 a third Model, the Proposed Model Income Tax Treaty, was published by the United States Treasury Department⁹³¹.

⁹²³ Those were with Australia, Austria, Belgium, Denmark, Finland, Germany, Greece, Ireland, Italy, Japan, the Netherlands, New Zealand, Norway, Pakistan, South Africa, Switzerland and the United Kingdom.

⁹²⁴ 6 U.S.T. 3696, T.I.A.S. No.3366.

⁹²⁵ 10 U.S.T. 1358, T.I.A.S. No.4280.

⁹²⁶ 9 U.S.T. 1459, T.I.A.S. No.4141.

⁹²⁷ Those were with Belgium, Brazil, Finland, France, Iceland, Israel, Japan, Korea, Luxembourg, Philippines, Poland, Romania, Thailand, Trinidad and Tobago, the United Kingdom and the U.S.S.R..

⁹²⁸ Daily Tax Reporter, No.97(18.5.1976); The United States Treasury, Treasury Department's Model Income Tax Treaties, United States Treasury Press Release, 18.5.1976, 41 Federal Regulations 20, 427(1976). United States Department of the Treasury, "Model Income Tax Treaty of 17 May 1977", *Bulletin for International Fiscal Documentation*, Vol.31(1977), p.313.

⁹²⁹ Daily Tax Reporter, No.99(20.5.1977); The United States Treasury Department's Model Income Tax Treaty of May 17, 1977 reprinted in *Tax Treaties(CCH)*, Vol.1(1981), p.153 and U.S. Department of The Treasury, "Model Income Tax Treaty of 17.5.1977", *Bulletin of International Fiscal Documentation*, Vol.31(1977), p.313.

⁹³⁰ The United States Federal Regulations, Vol.41, No.20,427 (1976); Vol. 42, No: 25,394 and 25,395 (1977).

⁹³¹ Daily Tax Reporter, No.115(16.6.1981); The United States Department of the Treasury, "Model Income Tax Treaty of 16.6.1981", *Bulletin of International Fiscal Documentation*, Vol.36(1982), p.15; The New York State Bar Association Tax Section - Committee on United States Activities of Foreign

An alternative draft of Article 16 (treaty shopping) of the third Model was published on 23.12.1981⁹³². In practice, the latter Model was served as the US Model Treaty⁹³³. The United States Treasury was planning to publish a revised Model Treaty with a technical explanation⁹³⁴ and on 20.9.1996 the United States Model Income Tax Convention⁹³⁵ is published⁹³⁶.

The United States tax treaties come into force after the advice and consent of the United States Senate, approval by the President of the United States and the exchange of instruments of ratification⁹³⁷.

The United States adopts residence principle for international shipping and air transportation under its own model treaty⁹³⁸. Article 8, which concerns shipping and air transport like the OECD and the United Nations Models, is as follows:

1- Profits of an enterprise of a Contracting State⁹³⁹ from the operation of ships or aircraft in international traffic shall be taxable only in that State.

Taxpayers, "Report on Proposed United States Model Income Tax Treaty", 27.4.1982, *Harvard International Law Journal*, Vol.23(1983), No.2, p.219.

⁹³² The United States, "Treasury Department Model Income Tax Treaty", *Tax Treaties(CCH)*, Vol.1(1981), p.211 and *Bulletin for International Fiscal Documentation*, Vol.36(1982), p.15; Helmut Becker - J.Felix Wurm: "Treaty Shopping", *Intertax*, Special Issue-1987, p.2; P. Lerner - M. Lebowitz - J. Pridjian: "Treaty Shopping and US Tax Policy: New Approaches", *Tax Planning International Review*, 1992, pp.32-34.

⁹³³ Vogel, op. cit., p.10; See for the United States tax treaty policy and procedure: Joint Committee on Taxation, *Background and Issues Relating to the Taxation of Foreign Investment in the United States*, The United States Government Printing Office, Washington, 1990, pp.43-55.

⁹³⁴ Bennett, op. cit., p.339.

⁹³⁵ [Http://www.ustreas.gov/treasury/tax/t0txmod1.html](http://www.ustreas.gov/treasury/tax/t0txmod1.html).

⁹³⁶ Hereinafter referred as 1996 U.S. Model.

⁹³⁷ The United States Constitution, Article II, section 2.

⁹³⁸ The United States Model Income Tax Convention of 20.9.1996. See, *infra.*, p.7.

⁹³⁹ An "enterprise of a contracting state" is an enterprise carried on by a resident of a contracting state. (U.S. Model Convention, Article 3(1)(c).)

2- *For the purposes of this Article, profits from the operation of ships or aircraft include profits derived from the rental of ships or aircraft on a full (time or voyage) basis. They also include profits from the rental of ships or aircraft on a bareboat basis if such ships or aircraft are operated in in international traffic by the lessee, or if the rental income is incidental to profits from the operation of ships or aircraft in international traffic. Profits derived by an enterprise from the inland transport of property or passengers within either Contracting State, shall be treated as profits from the operation of ships or aircraft in international traffic if such transport is undertaken as part of international traffic.*

3- *Profits of an enterprise of a Contracting State from the use, maintenance, or rental of containers (including trailers, barges, and related equipment for the transport of containers) used in international traffic shall be taxable only in that State.*

4- *The provisions of paragraphs 1 and 3 shall also apply to profits from participation in a pool, a joint business, or an international operating agency.*

There are differences and similarities between the United States Model and the OECD Model⁹⁴⁰:

1- The residence principle is used in paragraph 1 of Article 8 of the United States Model regarding profits from the operation of ships or aircraft in international traffic in contrast to the place of effective management principle in the OECD Model Article 8 and the United Nations Model Article 8A and Article 8B (only for air transportation).

2- In the matter of double taxation the United States Model applies the credit method, but the OECD Model uses the exemption and credit method⁹⁴¹.

3- United States Model Convention Article 8 is extended to cover bareboat charters⁹⁴², in contrast to the OECD and United Nations Model treaties.

⁹⁴⁰ See, Richard L. Doernberg, *International Taxation in a Nutshell*, West Publishing Co., St. Paul-Minneapolis-1989, pp.78-79.

⁹⁴¹ *Supra*, p.15.

⁹⁴² Patrick, *op. cit.*, p.653; New York State Bar Association-Tax Section, *op. cit.*, p.253.

4- For the purposes of Article 8, the income from the rental of ships, aircraft and containers is essentially similar to income from international shipping and air transport⁹⁴³.

The residence principle has been used, for example, in double taxation agreements with Austria⁹⁴⁴, Czech Republic⁹⁴⁵, Denmark⁹⁴⁶, Finland⁹⁴⁷, France⁹⁴⁸, Germany⁹⁴⁹, Hungary⁹⁵⁰, Italy⁹⁵¹, Luxembourg⁹⁵², Portugal⁹⁵³, Russia⁹⁵⁴, Spain⁹⁵⁵, Sweden⁹⁵⁶ and Switzerland⁹⁵⁷.

The definition of "international traffic" in the 1996 United States Model Treaty is the same as in the 1977 and 1981 United States Model Treaties⁹⁵⁸. However, Article 8 had been subject to two changes between the 1977 and 1981. The 1981 Model omitted "*on a full or bareboat basis*" in paragraph 1 and "*...for transport...*" from the phrase "*...containers...used for transport in international commerce...*" in paragraph 3.

Some double taxation agreements can be given as an example for the determination of transportation. For example, under the United States - Netherlands tax

⁹⁴³ The United States Model, Articles 8(2) and 8(3).

⁹⁴⁴ 30.5.1996, ETSC 1 No.9(1996).

⁹⁴⁵ 19.9.1993, ETSC 3 No.3(1994).

⁹⁴⁶ 6.5.1948, ETSC 3 No.2(1995).

⁹⁴⁷ 21.8.1989, ETSC 4 No.2(1991).

⁹⁴⁸ 31.8.1994, ETSC 5 No.2(1996).

⁹⁴⁹ 29.8.1989, ETSC 6 No.1(1995).

⁹⁵⁰ 12.2.1979, ETSC 6 No. 1(1979).

⁹⁵¹ 17.4.1984, ETSC 7 No.3(1990).

⁹⁵² 3.4.1996, ETSC 8 No.7(1996).

⁹⁵³ 6.8.1994, ETSC 10 No.3(1996).

⁹⁵⁴ 17.6.1992, ETSC 10 No.11(1996).

⁹⁵⁵ 22.2.1990, ETSC 10 No.6(1991).

⁹⁵⁶ 1.9.1994, ETSC 11 No.12(1995).

⁹⁵⁷ 2.10.1996, (Not yet in force).

⁹⁵⁸ Article 3(1).

treaty⁹⁵⁹, some activities are within the context of the operation of ships. Both countries agreed on following words⁹⁶⁰:

"In view of the fact that shipping companies are utilising the container method of ocean transportation, certain ancillary activities connected with container transportation would be included within the provision applicable to the operation of ships in international traffic."

However, for the United States Internal Revenue any gain from the disposition of any United States real property is not treated as income from the international operation of ships and aircraft⁹⁶¹.

Under United States - Germany double taxation agreement⁹⁶² both states agreed to interpret the term "operation of ships" in the same manner as under United States - Netherlands tax treaty⁹⁶³.

In a dispute between the United States and Australia⁹⁶⁴, an Australian registered corporation engaged in international air transportation sold many of its obsolete aircraft, spare engines and spare parts that were used in the company's business, within the United States. The question was whether the income from the sales of this equipment was to be subject to United States income tax⁹⁶⁵.

Under Article V(1), of the United States - Australia Tax Convention, profit derived by an Australian resident from operating ships or aircraft registered in Australia shall be exempt from United States Federal Income Tax.

Also under Article II(2), "...in the application of the provisions of the Convention by one of the Contracting States any term, not otherwise defined shall,

⁹⁵⁹ 29.4.1948, T.D. 5778, 1950-1 C.B. 92 and 1967-2 C.B.472.

⁹⁶⁰ The Revenue Ruling 76-568 (IRB 1976-52, 76).

⁹⁶¹ The Revenue Ruling 90-37, 1990.

⁹⁶² TIAS 3133, 1955-1 C.B. 635.

⁹⁶³ *Supra.*, p.233.

⁹⁶⁴ *Edwardes-Ker, op. cit.*, p.8 of Article 8.

⁹⁶⁵ The Revenue Ruling 72-624 (1972-2 C.B. 659).

unless the context otherwise requires, have the meaning that it has under the laws of that State relating to the taxes that are the subject of the Convention."

The Revenue Ruling stated, after examining the related sections of Internal Revenue Code of 1954⁹⁶⁶ that the income from the sales of obsolete aircraft, spare engines and spare parts in the United States was within the context of Article V(1) of the United States - Australia Tax Convention, and was therefore exempt from United States Federal Income Tax. The Revenue Ruling also mentioned that the sales occurred because of technological necessity rather than the liquidation of the business⁹⁶⁷. Otherwise, the income would not be within the context of operation of ships or aircraft.

About residency, the United States Model Article 4 has some differences in contrast to the OECD and the United Nations Models. It states that:

"1- Except as provided in this paragraph, for the purposes of this Convention, the term 'resident of a Contracting State' means any person, who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, citizenship, place of management, place of incorporation, or any other criterion of a similar nature.

a- this term does not include any person who is liable to tax in that State in respect only of income from sources in that State or capital situated therein; and

b- A legal person organized under the laws of a Contracting State and that is generally exempt from tax in that State and is established and maintained in that State either:

i- exclusively for a religious, charitable, educational, scientific, or other similar purpose;

or

ii- to provide pensions or other similar benefits to employees pursuant to a plan is to be treated for purposes of this paragraph as a resident of that Contracting State.

c- A qualified governmental entity is to be treated as a resident of the Contracting State where it is established.

d- An item of income, profit or gain derived through an entity that is fiscally transparent under the laws of either Contracting State shall be considered to be derived by a resident of a State to the

⁹⁶⁶ 1954 IRC, Sections 872(b)(2) and 883(a)(2).

⁹⁶⁷ Edwardes-Ker, op. cit., p.8 of Article 8; See, the Revenue Ruling 72-624, 1972.

extent that the item is treated for purposes of the taxation law of such Contracting State as the income, profit or gain of a resident.

...

3- Where by reason of the provisions of paragraph 1 a company is a resident of both Contracting States, then if it is created under the laws of a Contracting State or a political subdivision thereof, it shall be deemed to be a resident of that State.

4- Where by reason of the provisions of paragraph 1 a person other than an individual or a company is a resident of both Contracting States, the competent authorities of the Contracting States shall settle the question by mutual agreement and determine the mode of application of the Convention to such person."

In the United States Model the citizenship and the place of incorporation are added to the criteria placed in the first paragraph.

The third paragraph of the United States Model is related to dual residency. If the company is dual resident, the place of incorporation will be company's residence. If dual residency exists for a person other than an individual or a company, the competent authorities of the contracting states will solve the problem.

The United States applies only to the "incorporation" test. A company is non-resident if its place of incorporation is outside the United States. The existence of, for example, the place of effective management does not establish residency for a foreign company in the United States.

In *Taisei Fire and Marine Insurance Co. Ltd. et al. v. Commissioner*⁹⁶⁸, the question was whether the existence of an agent is sufficient for four Japanese companies to be deemed to have a permanent establishment. The Tax Court checked all the facts and circumstances and found that the agent had no legal and economic dependence on the principal, therefore, permanent establishment did not exist for the foreign enterprise⁹⁶⁹.

For the existence of legal dependence, the court reviewed the actual control of the foreign principal on the agent, contractual arrangements and control over the

⁹⁶⁸ (1995), 104 TC 535 in Davison, op. cit., p.102.

⁹⁶⁹ Davison, p.108.

business practices between them, the agent's administrative structure which led the court to decide that the agent was independent.

Also, there was no guarantees of profits or stop-loss arrangements between the parties and the principals could terminate the relationship with reasonable notice which was found sufficient by the court to established that, there was no economic dependence⁹⁷⁰.

In *De Amodio v. Commissioner*⁹⁷¹, the United States Tax Court found that a non-resident was not carrying on a trade or business in the United States despite the fact that he had received business income from rental property in the United States which has been run by an independent company hired by the non-resident.

3- Taxation of International Transportation Companies' Income

Three important changes have been made by the 1986 Tax Reform Act⁹⁷² regarding taxation of international transportation income in the United States.

a- 4% Gross Basis Tax

In 1986 the United States Congress imposed a 4% gross basis tax⁹⁷³ on non-resident foreign individuals' and corporations' United States source gross transportation income without deductions⁹⁷⁴.

However, when a non-resident corporation maintains a trade or business within the United States during a taxable year in which it is effectively connected⁹⁷⁵ with the

⁹⁷⁰ Davison, pp.108-109.

⁹⁷¹ 34 T.C. 894 (1960), 299 F.2d 623 (1962) in Tremblay, op. cit., p.309.

⁹⁷² Supra., p.2.

⁹⁷³ IRC, Section 887; The offer to change the rate from 4 % to 8 % is rejected by the Ways and Means Committee on 27.7.1994 - Barbara Kirchheimer, "Ways and Means Approves \$1 Billion in Increased Shipping Fees, News Digest, *Tax Notes International*, 8.8.1994, p.419.

⁹⁷⁴ This is included in Section 887(a) and was applicable from 1.1.1987 (IRC, Section 1212(b)).

United States, its income is subject to the regular corporate tax rate of up to 35%⁹⁷⁶, after allowable deductions.

The Internal Revenue Code imposes two requirements, which apply together, to determine whether non-resident transportation corporations' income is effectively connected with the conduct of a trade or business in the United States:

a- If the taxpayer has a fixed place of business in the United States to earn transportation income, its United States source gross transportation income is considered effectively connected transportation income.

b- If substantially all⁹⁷⁷ of the taxpayer's United States source gross transportation income derives from regularly scheduled transportation, which is not defined in the Income Tax Act, this income is effectively connected transportation income⁹⁷⁸.

When a foreign corporation fails either of these tests, its income will be subject to 4% gross basis tax. It is not important whether the company makes a profit or not.

The important point here is that although the Internal Revenue Code Section 887(b)(4)(a) refers to only a *"If the taxpayer has a fixed place of business in the United States to earn transportation income, its United States source gross transportation income is considered effectively connected transportation income."*, the Internal Revenue Code section 864(c)(4)(B) states *"Income, gain or loss from sources without the United States shall be treated as effectively connected with the conduct of trade or business within the United States by a non-resident alien individual or a foreign corporation if such person has an office or other fixed place of business within the United States ..."*. In this context, United States source transportation income is not limited by being attributable to a fixed place of business but also includes income attributable to an office.

⁹⁷⁵ The American Law Institute has made some recommendations about effectively connected income see, The American Law Institute, *Federal Income Tax Project - International Aspects of United States Income Taxation*, Philadelphia-1987, pp. 78-85.

⁹⁷⁶ See, *supra*, 230.

⁹⁷⁷ "Substantially all" in this context means 90% or more (The Revenue Ruling 91-12, 1991-1 C.B. 474, Section 4.06).

⁹⁷⁸ IRC, Sections 887(b)(4) and 887(b)(4)(B); also see 864(c).

Regularly scheduled transportation occurs when a ship or aircraft follows a published schedule with repeated sailings or flights, as the case may be, at regular intervals between the same points for voyages or flights which begin or end in the United States⁹⁷⁹.

Air transportation, in this context, includes both scheduled and chartered air carriers. On the other hand, tramp shipping that has no fixed route, no regular time of sailing and travels from port to port in search of cargo to transport is not within the concept of the term "regularly scheduled transportation"⁹⁸⁰.

The leasing income of vessel or aircraft will not be treated as effectively connected with the conduct of trade or business within the United States, unless⁹⁸¹:

a- The foreign person maintains a fixed place of business in the United States involved in the earning of United States source gross transportation income; and

b- Substantially all of the person's United States source gross transportation income from leasing is attributable to that fixed place of business.

The term "leasing income" here includes income from the bareboat charter of vessel and aircraft but not time or voyage charter income from vessel or aircraft. They are considered income from the operation of vessel or aircraft⁹⁸².

The term "attributable to a fixed place of business" is defined so that, if transportation income derived from the bareboat lease of aircraft or vessels is effectively connected with a fixed place of business in the United States, it is attributable to a fixed place of business in the United States⁹⁸³.

⁹⁷⁹ The Revenue Ruling 91-12, 1991-1 C.B. 474, Section 4.03.

⁹⁸⁰ The Revenue Ruling 91-12, 1991-1 C.B. 474, Section 4.07.

⁹⁸¹ The Revenue Ruling 91-12, 1991-1 C.B. 474, Section 4.04.

⁹⁸² The Revenue Ruling 91-12, 1991-1 C.B. 474, Section 4.08.

⁹⁸³ The Revenue Ruling 91-12, 1991-1 C.B. 474, Section 4.09.

The income from the lease is attributable to a fixed place of business in the United States, even if the lease is subject to final approval of the foreign taxpayer, if the United States office actively participated in the negotiating the lease.

b- Reciprocal Exemption

Prior to the 1986 Tax Reform Act, when a foreign shipping company operated a ship which was registered in a country which granted an equivalent exemption to United States citizens and domestic corporations this enabled the foreign shipping company to be exempted from United States taxation.

The foreign shipping company's country of citizenship or incorporation was not important. For example, if a foreign company is registered in Norway, which does not grant an equivalent exemption to United States citizens and corporations, but flies the flag of Panama which does give relief, the company would be entitled to an exemption. This made it relatively easy to take advantage of the exemption.

The Tax Reform Act of 1986 changed the rules for granting equivalent tax exemption⁹⁸⁴ to United States citizens and domestic corporations⁹⁸⁵. After 1986 changings, foreign shipping corporations are subject to United States tax exemption only if 50 per cent of shareholders resided in countries granting equivalent tax exemption to United States citizens and domestic corporations⁹⁸⁶. The new requirements, apply to transport companies who want to use reciprocal exemption rules, are the residence and the shareholder tests, known as the "*shareholder-based residence test*" or "*look-through rule*"⁹⁸⁷. The reason behind this policy is to encourage more countries to enter tax agreements with the United States⁹⁸⁸.

⁹⁸⁴ Supra., p.231.

⁹⁸⁵ The Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986*, CCH, U.S.A. - 1987, pp.926-927.

⁹⁸⁶ IRC, Sections 883(a)(1) and 883(c)(1); The Revenue Ruling 87-15, 1987-6 IRB 15.

⁹⁸⁷ IRC, Section, 883(c). Although the original rate of the look-through rule was 75% in the House version, it was reduced to 50% by the Senate.

⁹⁸⁸ The Joint Committee on Taxation, op. cit., pp.926-927.

After the 1986 changes, the foreign shipping companies who fly with a flag of convenience, cannot apply for reciprocal exemption when their country of residence or incorporation does not grant reciprocal exemption to United States citizens and corporations.

One of the problems is that, it is not clear if this provision will apply to a corporation resident in a jurisdiction which imposes no tax on any business operation or imposes an extremely low rate of tax, such as Barbados. For example, Revenue Canada's attitude is generally towards the extension of the exemption of corporations' resident in countries which impose no income tax⁹⁸⁹.

The reciprocal exemption system could apply appropriately between countries where the international traffic is equal or at least similar. Otherwise, only one country gains tax revenues and this is especially likely in the context of agreements between developed and developing countries. When the developed country gains revenue under reciprocal exemption, the developing country loses the opportunity to tax this income. Since developing countries do not have a developed transportation system, reciprocal exemption does not effect the developed countries' level of tax revenues negatively.

One impact of reciprocal exemption is to reduce the price of shipping services, because, after the reciprocal exemption international transportation companies will not be subject to double tax and for this reason, they will not have to pass on the cost to the customer⁹⁹⁰. In a competitive market place it is the consumer who ultimately benefits from exemption from taxes⁹⁹¹.

Another problem related to reciprocal exemption is the question of how one is to determine the taxable amount of the income of the foreign transportation companies. In most cases, the foreign transportation companies will use an agent in a local office. Where the agent is paid on a commission basis the amount at which he is paid might form starting point for the assesment of the company's income⁹⁹².

⁹⁸⁹ The Revenue Canada - 1991 Technical Interpretation, p.4.

⁹⁹⁰ Field-Gordon, op. cit., p.71.

⁹⁹¹ Idem.

⁹⁹² Ibid., p.83.

Otherwise, the international transportation companies may give false or no information about the actual amount of their transportation income which could be subject to tax in that country.

It is quite interesting to note that, until recently some states in the United States did not recognise the exemption of foreign shipping and airline company income under section 883(a) of the Internal Revenue Code. For example, New Jersey began to recognise the exemption under section 883 only after 1994⁹⁹³.

The reciprocal exemption could be effective only between countries that have similar or same level of international transport business. Otherwise, only one country gains benefits and in most cases they are developed countries. Since developing countries do not have developed transportation businesses, they can not increase their tax revenues, if they use source principle, under the reciprocal exemption.

The new "*shareholder-based residence test*" will make it more difficult for shipping companies to escape taxation on their United States source income as the residence of the shareholders of the company becomes relevant instead of only the residence of the company.

The look-through rules will deny reciprocal corporate exemption unless more than 50 percent of the value of the stock of such corporation is owned by individuals who are qualified residents⁹⁹⁴ of another qualified foreign country meeting the corporate exemption requirements of Sections 883(a)(1) or (2)⁹⁹⁵.

A look through rule does not apply to a qualified publicly traded corporation and controlled foreign corporations⁹⁹⁶. A qualified publicly traded corporation is a company which is organized in a qualified foreign country, the stock of which is primarily⁹⁹⁷ and

⁹⁹³ Charles M. Costenbader: "New Jersey Tax Division Recognizes Federal Exemption of Foreign Shipping and Airline Company Income", *Tax Notes International*, 25.7.1994, p.232.

⁹⁹⁴ *Infra.*, p.265.

⁹⁹⁵ IRC, Section 883(c)(1).

⁹⁹⁶ IRC, Sections 951 and 954; See, *infra.*, p.?

⁹⁹⁷ "Primarily" means that more shares trade in the country of organizations than in any other country. The Senate Report, at pp.343-344.

regularly traded on an established securities market in the foreign country in which such a corporation is organized or in the United States⁹⁹⁸.

When examining the look-through rule one observes its fragile situation. This is a 50/50 rule, which means that 50 percent of a corporation's stock value must be held by qualified residents. If 49 per cent is held by qualified residents, the entire amount of the United States source gross transportation income would be subject to tax, but if a single share were to be transferred to a qualified resident, 100 percent of the gross income would be exempted⁹⁹⁹.

It is very probable that the qualified residents who hold less than 50 percent of a corporation's stock will always attempt to transfer the necessary shares to reach the 50 per cent threshold to qualify for full exemption.

Furthermore, it is important to remember that, if shipping and aircraft income is exempted under any United States tax convention, the corporate exemption look-through rules do not apply¹⁰⁰⁰.

When shipping companies ultimate shareholders reside in the company's incorporated country which grants an equivalent exemption or they are citizens of another foreign country which grants an equivalent exemption to United States citizens and corporations, the reciprocal exemption will apply to a foreign corporation.

The reciprocal exemptions also apply to all rental income from leasing ships and aircraft on a full or bareboat basis¹⁰⁰¹.

All rental income from leasing ships and aircraft on a full or bareboat basis can qualify for reciprocal exemption under the 1986 Internal Revenue Code. Prior to the Code only incidental rental income from the operation of ships and aircraft could qualify

⁹⁹⁸ IRC, Section 883(c)(3).

⁹⁹⁹ M. Kevin Outtersson - Chi K. Cheung, "Revenue Procedure 91-12: I.R.S. Launches Information - Gathering Offensive Against International Operations", *Tax Notes International*, May-1991, p.593.

¹⁰⁰⁰ The Revenue Ruling, 89-42, at 234.

¹⁰⁰¹ The House of Representatives Report, No. 841, 99th Congress, 2nd Session II-598; Levine-Berger, op. cit., p.1217; Tsiros, op. cit., p.387.

for reciprocal exemption. Also both United States and other country can apply reciprocal exemption on a partial basis if they agree¹⁰⁰².

c- 50% Source Rule

With the Tax Reform Act of 1986, 50 per cent of all transportation income attributable to transportation which *begins or ends* in the United States is treated as United States source income¹⁰⁰³. Also, Section 863(c)(1) still provides that all transportation income attributable to transportation which *begins and ends* in the United States is treated as United States source income.

Prior to 1986, the foreign corporations' income from transportation to or from the United States as allocated between the United States and foreign sources according to how long the ship or aircraft was within United States territorial waters. Since the United States had a three-mile territorial limit and income from United States sources was limited to income deriving from the United States territorial waters or airspace. All income derived from outside the United States territorial waters or airspace was deemed to be foreign income¹⁰⁰⁴.

This rule was manipulated easily since very small portion of any voyage was spent within United States territorial waters or air space. For this reason, the United States revenue from taxation of foreign transportation companies was very low¹⁰⁰⁵.

The Internal Revenue Code applies without difficulty to allocate income of a non-stop flight between two destinations. For example, a direct flight between Washington and London presents no conflict of allocation of income. 50 per cent of the income would be considered United States source income under Section 863(c)(2).

¹⁰⁰² Levine-Berger, op. cit., p.1217.

¹⁰⁰³ IRC, Section 863(c)(2).

¹⁰⁰⁴ Field - Gordon, op. cit., p.70.

¹⁰⁰⁵ The Revenue Ruling 75-483, 1975-2 CB 286; Blue Book, pp.926-927; Zerbo, op. cit., p.235; Garrison, op. cit., p.152; Subcommittee of American Bar Association, op. cit., p.348; Jim Fuller: "United States 'Tax Reform Act of 1984'", *Taxes International*, No.57, July-1984, p.79; Outtersson-Cheung, op. cit., p.589, footnote 18.1.

However, a problem exists if the flight involves more than two destinations. If the flight stops in Toronto, for instance, ticket sales for the passengers who travelled from London to Toronto would not be considered as United States source income. The rules would apply only for the ticket sales for passengers who travelled from London to Washington and Toronto to Washington. For this reason it is necessary to make different allocations of incomes for different routes. The rule applies not only for passengers but also for cargo¹⁰⁰⁶.

Another problematic area is round-trip travel that begins and ends in the United States. Although air transportation presents no problem, a round-the-world cruise which begins and ends in United States presents important complications. According to the Blue Book¹⁰⁰⁷ only 50 percent of the income derived from the first and last legs of the cruise would be considered United States source. For that reason transportation companies would want to keep the first and last legs of cruise as short as possible to minimize United States source income¹⁰⁰⁸.

Also, another complexity exists if a foreign person bare boat charters the vessel to a second person, who time charters to a third foreign person, who voyage charters to a fourth foreign person, who derived freight from a number of other persons. This is known as a cascading chain¹⁰⁰⁹. All potentially have United States source gross transportation income, however, no legislative guidance is issued how this should be allocated between the United States and other tax jurisdictions.

Revenue Procedure 91-12 requires that a "reasonable method" be used and disclosed on the return¹⁰¹⁰. Although another reasonable method can be chosen by the lessor, the Internal Revenue Service has developed two methods to attribute transportation income:

- The "number of days" method.
- The "lessee-operator gross income" method.

¹⁰⁰⁶ The Senate Report, op. cit., p.341.

¹⁰⁰⁷ Blue Book, p.929.

¹⁰⁰⁸ Garrison, op. cit., p.154; Zerbo, op. cit., pp.235-236; Outtersson - Cheung, op. cit., p.590, footnote-23.

¹⁰⁰⁹ Zerbo, op. cit., p.237; Arnold C. Johnson: "Foreign Shipping Income Taxation After the Tax Reform Act of 1986", *The International Tax Journal*, Vol.14(1988), No.1, p.57.

¹⁰¹⁰ The Revenue Ruling 91-12, section 5.02.

The "number of days" method

This method¹⁰¹¹ utilizes the ratio of (a) the number of days uninterrupted travel between the United States and the farthest loading/unloading point to (b) the number of days in the smaller of the taxable year or charter period.

The number of days the vessel is located in United States water for repairs or maintenance should not be included in either the numerator or in the denominator of the ratio¹⁰¹².

The "lessee-operator gross income" method

This method utilizes the ratio of (a) the United States Source Gross Transportation Income earned from the operation of the vessel or aircraft by the lessee-operators to (b) the total gross income of the lessee-operator for the operation of the vessel or aircraft during the smaller of the taxable year or the term of the charter¹⁰¹³.

An allocation based upon the net income of the lessee-operator will not be considered "reasonable" for this purpose¹⁰¹⁴. however, there is no indication how this reasonable methods apply.

Although two methods have been developed by the Internal Revenue¹⁰¹⁵ which are not based on statute, it would be possible in the appropriate circumstances to argue for alternative methods, but no explanation has been provided to apply these methods.

In December 1986, the United States sent notice of the changes to the Code to foreign governments whose tax treaties contain the registry or "flag" limitation on shipping and aircraft income exemptions, and expressed an interest in modifying those provisions to conform to the new statutory rules.

¹⁰¹¹ Idem.

¹⁰¹² Idem.

¹⁰¹³ Idem.

¹⁰¹⁴ Idem.

¹⁰¹⁵ Supra., p.248.

The main reason for an increased United States taxation of international transportation companies with the Tax Reform Act of 1986 is to encourage countries to enter into reciprocal exemptions with the United States¹⁰¹⁶.

After the Tax Reform Act of 1986, a non-resident alien's gross income from the operation of ships or aircraft is excluded from the United States tax if it is the corporations country of residence or incorporation that grants a reciprocal exemption to United States citizens and corporations.

In addition, the shareholder based-residence test applies for international companies who want to benefit from a reciprocal exemption. Under this rule, the individual shareholders who own ultimately more than 50 per cent of shares of the international transportation corporation have to reside in foreign countries that grant a reciprocal exemption to United States citizens and corporations¹⁰¹⁷.

The timing, that is to say how long the shares are owned in any one year, for the 50 per cent ownership test is unclear¹⁰¹⁸. Individuals can satisfy 50 per cent of the value of the corporations' stock for a short term, however, in this case, it is not clear whether share-holders can apply to reciprocal exemption rules.

It might be appropriate to require that the 50 per cent ownership rule should be satisfied for a minimum period. One possible solution is that a maximum of 10 per cent of the days of the taxable year will be exempted to satisfy the rules (i.e. 36 days). In other words, share-holders should satisfy the 50 per cent rule in their company for at least 90 per cent of the days of the taxable year.

However, under the United States-Canada Treaty, Canadian national shareholders of foreign corporations are exempted from United States taxation even if they are residents of a country that does not grant an equivalent exemption¹⁰¹⁹. This is an exemption to the new reciprocal exemption rule of the 1986 Tax Reform Act. The reason may be the close relationship between two countries.

¹⁰¹⁶ Blue Book, op, cit., p.927.

¹⁰¹⁷ Supra., p.245.

¹⁰¹⁸ Garrison, op. cit., p.156.

¹⁰¹⁹ Levine-Berger, op. cit., p.1218.

On the other hand, an argument used against the use flags of convenience, is that they enable ship owners to evade tax. For example, in the United States, before the 1986 Tax Reform Act, many ship owners evaded tax on their United States source income by the use of a flag-of-convenience.

It has been expressed that, "because of the high degree of inter-governmental regulation governing scheduled flights, the flag-of-convenience phenomenon has not spread to aircraft, although it would appear that international air transport could be operated under a fiscal flag-of-convenience through the use of tax havens and aircraft leasing."¹⁰²⁰

In order to gain protection from international law, two requirement on ships are imposed. First, the state to which the vessel belongs has a right to protect the vessel. Second, the fact that the vessel must possess a national character generally means the place of registration and the flag of the vessel¹⁰²¹.

Another question that could be asked is the basis on which shipowners choose a suitable flag of convenience country for their fleet while the tax systems and other conditions are very similar or the same between them. The following quote from 1957 Senate Hearings in United States is quite surprising from the point of international tax law:

"The Chairman: Incidentally, I am curious, and there must be a reason, why did you go to Liberia instead of Panama?

Mr. Vander Clute: I can tell you that very easily. Liberia we look upon as the godson of the United States. The flag is the nearest thing to the United States flag, and Uncle Sam certainly would have control over Liberian ships..."¹⁰²²

However, regarding international competition, the shipping companies check the smallest tax detail and other financial opportunities given by the flag of convenience countries to find the most suitable place for ship registration.

¹⁰²⁰ Davies, op. cit., p.141, footnote-74.

¹⁰²¹ N.P. Ready, *Ship Registration*, Lloyd's of London Press Ltd., London-1991, pp.1-2.

¹⁰²² Boleslaw Adam Boczek, *Flags of Convenience*, Harvard University Press, Cambridge-1962, p.63.

Using a flag-of-convenience is one way to escape from tax in the companies' original countries. Since many shipping companies use this method it has acquired almost general acceptance. However, it does erode the tax revenues of the country of origin, and will continue to be as popular in the future as it is today, because, even the smallest reduction in tax provides an advantage to the transportation companies in the very competitive international market.

4- Definitions

a- "United States"

The term "United States" when used in a geographical sense includes only the States and the District of Columbia¹⁰²³.

b- " United States Source Gross Transportation Income"

"*United States source gross transportation income*" is defined in Internal Revenue Code section 887(b)(1) as "*...any gross income which is transportation income to the extent such income is treated as from sources in the United States under section 863(c)(2).*"

Section 863(c)(2), as been implemented by 1986 Tax Reform Act, states that "*50 percent of all transportation income attributable to transportation which begins or ends in the United States is treated as from sources in the United States*".

Also, section 863(c)(1)¹⁰²⁴ states that "*all transportation income attributable to transportation which begins and ends in the United States shall be treated as derived from sources within the United States*". This rule still exists after the 1986 changes. The provision applies to both United States and foreign persons.

Before the Tax Reform Act of 1986, 50 percent of all transportation income attributable to transportation which (a) began in the United States and ended in a United States possession¹⁰²⁵ or (b) began in a possession of the United States and ended in the

¹⁰²³ IRC, Section 7701(a)(9).

¹⁰²⁴ The Tax Reform Act of 1984, Public Law, 98-369, section 124(a), 98 Stat. 494 (1984).

¹⁰²⁵ Such as Puerto Rico or the Virgin Islands.

United States is treated as United States source income. The other 50 per cent was treated as foreign source income¹⁰²⁶.

Also, under the Revenue Ruling 91-12, some transportation income does not fall within the context of United States source gross transportation income as follows:

1- not sourced under section 863(c)(2)¹⁰²⁷;

2- derived by individuals from personal services (i.e. crew wages) which they perform, unless such income is attributable to transportation which begins in the United States and ends in a possession of the United States, or begins in a possession of the United States, pursuant to section 863(c)(2)(B);

3- taxable as effectively connected with the taxpayer's trade or business¹⁰²⁸ in the United States pursuant to section 887(b)(4); or

4- taxable in a possession of the United States under a provision of the Code, as made applicable in such possession (i.e., under a "mirror" code)¹⁰²⁹.

c- "Transportation Income"

"*Transportation Income*" is defined in section 863(c)(3) as:

" 'transportation income' means *any income derived from or in connection with*

- the use (or hiring or leasing for use) of a vessel or aircraft, or

- the performance of services directly related to the use of a vessel or aircraft."

¹⁰²⁶ IRC, Section 1212(a).

¹⁰²⁷ Supra., p.252.

¹⁰²⁸ Supra., p.241.

¹⁰²⁹ IRC, Section 863(c)(2)(B).

ca- The use (or hiring or leasing for use) of a vessel or aircraft

The income which is derived from the leasing of a vessel but not used to transport is not transportation income. This income is from space and ocean activity¹⁰³⁰.

The Revenue Procedure 91-12 defines gross transportation income in this context as follows:

- income derived from transporting passengers or property on a vessel or aircraft;
- income derived from hiring or leasing a vessel or aircraft for use in the transportation of passengers or property; and
- income derived by an operator of a vessel or aircraft from the rental or use of containers and related equipment, in connection with, or incidental to, the transportation of cargo on such vessels or aircraft by the operator¹⁰³¹.

If a person other than an operator of a vessel or aircraft derives container related income, it is not transportation income but rental income.

Because there is no definition of the term "use", which person other than an operator may derive gross transportation income is problematic¹⁰³². It is difficult for a non-operator to know whether a ship or aircraft has travelled to or from the United States.

¹⁰³⁰ IRC, Section 863(d); The Senate Report No.313, 99th Cong., 2d Sess., 341 (29.5.1986).

¹⁰³¹ The Revenue Ruling 91-12, Section 2.04.

¹⁰³² Outtersen-Cheung, op. cit., p.589.

cb- The performance of services directly related to the use of a vessel or aircraft

In this context, two types of income, on board and off board, are defined as a gross transportation income by the Revenue Procedure 91-12:

- On board services performed by the operator (or a related person under I.R.C. section 954(d)(3)) in the course of the actual transportation of passengers or property (examples include renting staterooms, furnishings, meals and entertainment; operating shops or casinos; providing excess baggage storage; individual personnel service income; and income from demurrage, dispatch and dead freight)¹⁰³³; and

- Off-board services performed by the operator that are incidental to the operation of a vessel or aircraft by the operator, (examples include: terminal services such as dockage, wharfage, storage, lights, water, refrigeration, refueling and similar services; maintenance and repairs; and services performed by the operator as a travel or booking agent. Services provided by persons other than the operator are not off-board services)¹⁰³⁴.

The term "*operator*" includes the owner/operator of a vessel or a aircraft and time or voyage charterer¹⁰³⁵.

A related person is an individual, partnership, trust, estate, foreign or domestic corporation who owns more than 50 per cent of the combined voting power¹⁰³⁶.

Although the definition includes a related person¹⁰³⁷ for on-board services, only the operator is mentioned for off-board services. In accordance with this definition if a person who is not an operator provides off-board services, the income attributable to

¹⁰³³ The Revenue Ruling 91-12, Section 2.05(1).

¹⁰³⁴ The Revenue Ruling 91-12, Section 2.05(2).

¹⁰³⁵ The Revenue Ruling 91-12, Section 2.06.

¹⁰³⁶ The United States Tax Regulation 1.954 A-1.

¹⁰³⁷ IRC, Section 954(d)(3).

off-board services is not United States gross transportation income but it is effectively connected income.

When the same company or agency provides on-board and off-board services as a related person, the allocation of income is problematic because the company or agency has related person status for on-board services, but not for off-board services. For this reason, income from on-board services will be within the context of transportation income, but income from off-board service will not fall into the definition of transportation income.

The following activities of the shipping company will be treated as income from the operation of ships:

- 1- Providing the containers and special undercarriages for transportation to the port of departure and on board the ship during the ocean transportation;
- 2- Transferring the containers from the undercarriages or from railway carriages on board the ship;
- 3- Transportation on board the ship;
- 4- Unloading the containers on special undercarriages or railway carriages in the port of destination;
- 5- Providing the containers and special undercarriages for transportation from the port of destination to the customer¹⁰³⁸.

The term "foreign base company shipping income" is defined in Section 954(f) of the Internal Revenue Code that:

"...the term 'foreign base company shipping income' means income derived from, or in connection with, the use (or hiring or leasing for use) of any aircraft or vessel in foreign commerce, or from, or in connection with, the performance of services directly related to the use of any such aircraft, or vessel, or from the sale, exchange, or other disposition of any such aircraft or vessel..."

¹⁰³⁸ The Revenue Ruling 74-92 (1974-8 I.R.B. 14).

The term includes the following that are placed in the Income Tax Regulations:

- 1- Gross income derived from, or in connection with, the use (or hiring or leasing for use) of any aircraft or vessel in foreign commerce
- 2- Gross income derived from, or in connection with, the performance of services directly related to the use of any aircraft or vessel in foreign commerce.
- 3- Gross income incidental to income
- 4- Gross income derived from the sale, exchange or other disposition of any aircraft or vessel used or held for use (by the seller or by a person related to seller) in foreign commerce
- 5- In the case of a controlled foreign corporation dividends, interest, and gains described in article 954(f)
- 6- Income described in article 954 (g) (relating to partnerships, trusts, etc.)
- 7- Exchange gains, to the extent allocable to foreign base company shipping income¹⁰³⁹.

"*Foreign commerce*" means an aircraft or vessel used in foreign commerce to the extent it is used in transportation or property or passengers between a port or airport in the United States or possession of the United States and a port or airport in a foreign country, or between a port or airport in a foreign country and another in the same country or between a port or airport in one foreign country and one in another foreign country.

¹⁰³⁹ The United States Income Tax Regulations, 1.954-6.

For example, a trawler, a factory ship, and an oil drilling ship are not considered to be used in foreign commerce while a cruise ship which visits one or more foreign ports is considered to be so used¹⁰⁴⁰.

The term "*port*" includes any place (whether on or off shore) where aircraft or vessels are accustomed to load or unload goods or to take on or let off passengers¹⁰⁴¹.

Income derived from transporting passengers or property by aircraft or vessel in foreign commerce and income derived from hiring or leasing aircraft or vessel to another for use in foreign commerce is within the context of "income derived from , or in connection with, the use (or hiring or leasing for use) of any aircraft or vessel in foreign commerce"¹⁰⁴².

The following examples can be given in this context¹⁰⁴³:

Example-1: C is a foreign corporation. D is also a foreign corporation which hired a foreign flag vessel from C under a long term charter. D uses the vessel as a tramp ship to carry bulk and packaged cargoes and sometimes passengers between a port in the United States and a port in a foreign country or between foreign ports.

Although the payment by D to C for the charter hire constitutes income derived from the use of the vessel in foreign commerce, it is not foreign base company income. Also the charter hire and freight and passenger revenue (including demurrage and dead freight) derived by D also constitutes income from the use of vessel in foreign commerce, but it is not a foreign base company income.

Example-2: Foreign corporation F hired a foreign flag tanker from E under a long term bareboat charter to use in foreign commerce. The vessel engaged in carrying oil which was produced by F, to other countries and the United States. At other times the ship is used to use as a tramp ship in foreign commerce.

¹⁰⁴⁰ The United States Income Tax Regulations, 1.954-6(a)(3).

¹⁰⁴¹ The United States Income Tax Regulations, 1.954-6(a)(3)(iii).

¹⁰⁴² The United States Income Tax Regulations, 1.954-6(a)(5)(c).

¹⁰⁴³ The United States Income Tax Regulations, 1.954-6(a)(2).

The income from the charter hire between E and F derives from the use of vessel in foreign commerce. Also E's income from tramp shipping derives from the use of the vessel in foreign commerce.

The services in this context which constitute income in foreign commerce by a person who is related such as the owner, lessor, lessee or operator etc., are the following:

- 1- Terminal services, such as dockage, wharfage, storage, lights, water, refrigeration, and similar services,
- 2- Stevedoring and other cargo handling services,
- 3- Container related services (including the rental of containers and related equipment) performed either in connection with the local drayage or inland haulage of cargo or in the course of transportation in foreign commerce,
- 4- Services performed by tugs, lighters, barges, scows, launches, floating cranes, and other similar equipments,
- 5- Maintenance and repairs,
- 6- Training of pilots and crews,
- 7- Licensing of patents, know-how, and similar intangible property developed and used in the course of foreign base company shipping operations,
- 8- Services performed by a booking, operating, or managing agent, and
- 9- Any service performed in the course of the actual transportation of passenger or property¹⁰⁴⁴.

¹⁰⁴⁴ The United States Income Tax Regulations, 1.954-6(d)(2).

Also, some of the services are especially for the passenger, consignor, or consignee. They are provided by operator or a person related to the operator that includes:

- 1- Services described between 1 and 4 above and 9.
- 2- The rental of staterooms, berths, or living accommodations and the furnishing of meals.
- 3- Barber shop and other services to passengers aboard vessels.
- 4- Excess baggage, and
- 5- Demurrage, dispatch, and dead freight¹⁰⁴⁵.

However, some transportation companies' income is incidental, such as:

- 1- Gain from the sale exchange or other disposition of assets
- 2- Income derived from temporary investments
- 3- Interest on accounts and evidences of indebtedness
- 4- Income derived from granting concessions to others aboard aircraft or vessels used in foreign commerce.
- 5- Income derived from stock and currency futures
- 6- Income derived by the lessor of an aircraft or vessel used in foreign commerce from additional rentals for the use of related equipments (such as a complement of containers), and
- 7- Interest derived by the seller from a purchase money mortgage loan in respect of the sale of an aircraft or vessel¹⁰⁴⁶.

As an example, in the United States some incidental activities are accepted in the definition of the operation of a ship or aircraft in international traffic by Internal Revenue Service:

- the sale of passage tickets on behalf of other enterprises;
- the operation of a bus service connecting a town with its airport;
- advertising or commercial promotion of the shipping enterprise;
- transportation of goods by truck connecting a depot with a port or airport;

¹⁰⁴⁵ The United States Income Tax Regulations, 1.954-6(d)(2).

¹⁰⁴⁶ The United States Income Tax Regulations, 1.954-6(d)(2).

- transportation to deliver goods or persons to a final destination following an international air or sea voyage; and
- profits from the lease of containers that are incidental to the international operation of ships or aircraft¹⁰⁴⁷.

However, the International Revenue Service considers the following items do not constitute income earned from the operation of a ship:

- profits from what is clearly enterprise, such as the operation of a hotel;
- investment income of a shipping enterprise; and
- profits from an enterprise that utilises ships, but in a non-transportation activity such as offshore drilling.

Private letter rulings¹⁰⁴⁸ are another source of assistance in the determining of the meaning of income from international transportation. The following examples¹⁰⁴⁹ illustrate the problems:

Example-1: In this example¹⁰⁵⁰ there are two corporations: A Canadian corporation involved in international air transportation and a United States corporation involved in domestic air transportation.

The United States corporation wanted to operate a new international route. However, the capacities of its current fleet were not capable of flying non-stop from domestic point to foreign state so the United States corporation wanted to lease some of the Canadian corporation's long-flight capability aircraft. Also the Canadian corporation did not require the long-flight aircraft because of current route structure and increased fuel prices. Accordingly, the Canadian corporation found that the aircraft owned by the United States corporation better for themselves in the light of their level of business.

On 7.3.1983, the two corporations made an interchange agreement concerning swap-lease for three aircraft for a period of two years. The Canadian corporation's

¹⁰⁴⁷ The United States Income Tax Regulations, 1.954-6(d)(2).

¹⁰⁴⁸ *Supra.*, p.274.

¹⁰⁴⁹ Edwardes-Ker, *op. cit.*, pp.11-15.

¹⁰⁵⁰ The United States - Canada Letter Ruling, 84-31-046, 1984.

aircraft were registered in Canada and the United States corporation's aircraft were registered in the United States. Under the agreement the leased aircraft would remain registered in their original registered countries during the term of lease. Both corporations were not carrying on business of leasing its aircraft to others.

Under United States - Canada double taxation agreement Article V, income which an enterprise of one of the Contracting States derives from the operation of ships or aircraft registered in that State shall be exempt from taxation in the other Contracting State.

Income from the operation of aircraft is not defined in the agreement. The United States Revenue Ruling¹⁰⁵¹ defines earning derived from the operation of aircraft¹⁰⁵² as earnings which flow directly from such operation as well as incidental income derived from activities that are directly related to the conduct of such operation.

Earnings derived from the operation of a ship or ship¹⁰⁵³ includes the leasing of a bareboat chartered vessel if the owner is actively engaged in the shipping business and leases the vessel to another as an activity incidental to his shipping business¹⁰⁵⁴.

A Letter Ruling states that income from the lease of aircraft is within the context of the term income from the operation of ships or aircraft. Income from the operation of aircraft includes incidental income for the purposes of Article V of the double taxation agreement. These incomes are directly related with the operation of aircraft.

The leasing agreement between two corporations is a temporary agreement and for this reason the Canadian corporation's income from the lease is incidental income. Also, the Canadian corporation has a smaller amount of income from leasing than its air transportation business.

¹⁰⁵¹ The Revenue Ruling 72-624, 1972-2 C.B. 659, 1972.

¹⁰⁵² IRC, Sections 872(b)(2) and 883(a)(2).

¹⁰⁵³ IRC, Section 883(a)(1).

¹⁰⁵⁴ The Revenue Ruling 74-170 C.B. 175, 1974.

Example-2: In this example¹⁰⁵⁵, a Canadian company registered in Canada, is operating trucks as a common or contract carrier in Canada and between Canada and the United States. The company was investigating the tax implications of carrying goods by trucks from a point in Canada to a certain point in the United States. The Canadian corporation was not planning to operate between two points in the United States.

However, the goods must be inspected mandatorily by the United States Department of Agriculture after crossing the border before the destination points of the truck within the United States. The goods were to be unloaded and, after inspection, reloaded. After this inspection the trucks would be allowed to carry on to the destination point.

The problem was whether the inspection point is treated as a destination point and the transportation income between inspection point and the destination point is subject to United States tax.

Under Article VIII(4) of Canada - United States treaty, "profits of a resident of a Contracting State engaged in the operation of motor vehicles or a railway as a common carrier or contract carrier derived from the transportation of passengers or property between a point outside the other Contracting State and any other point shall be exempt from tax in that other Contracting State."

Although there was no definition of the term "point" in the treaty, it has been stated that the inspection point should not be treated as a "point" within the meaning of the treaty. It is not a destination point for the truck, therefore, the income derives from transportation between the inspection point and the destination point is not subject to tax in the United States and exempted under the Canada-United States treaty.

With this provision the Canadian company was exempted from United States Federal Income Tax on profits derived from truck transportation. The company was transporting between a point in Canada and a point in the United States and not carrying out any other transportation in the United States.

¹⁰⁵⁵ The United States - Canada Letter Ruling, 87-50-014, 1987.

d- "Vessel or Aircraft"

The term "*vessel or aircraft*"¹⁰⁵⁶ includes any container used in connection with a vessel or aircraft¹⁰⁵⁷.

The term "*vessel*" includes all water craft and other artificial contrivances of whatever description and at whatever stage of construction, whether launched or not, which are used or are capable of being used as a means of transportation on water¹⁰⁵⁸. Also a lighter or beacon lightship which serves other vessels used in foreign commerce is also considered to be used in foreign commerce¹⁰⁵⁹.

e- "Foreign Corporations"

Domestic and Foreign Corporations are defined by the Internal Revenue Service under Sections 7701(a)(4) and 7701(a)(5) of the Code: "*The term 'domestic' when applied to a corporation or partnership means created or organised in the United States or under the law of the United States or of any State*". Foreign corporations are those that are created or organised in any place other than the United States.

For domestic corporations the United States applies domicile jurisdiction. Thus, domestic corporations' worldwide income is subject to United States taxation. Conversely, for foreign corporations source jurisdiction is used. Thus, if a foreign corporation has income in the United States, it will be subject to the United States

¹⁰⁵⁶ IRC, Section 863(c)(3).

¹⁰⁵⁷ IRC, Section 863(c)(3) last paragraph.

¹⁰⁵⁸ The United States Income Tax Regulations, 1.954-6(a)(3)(ii).

¹⁰⁵⁹ The United States Income Tax Regulations, 1.954-6(a)(3)(iv).

taxation even if it does not have a domicile in the United States. With respect to source jurisdiction, foreign corporations pay taxes on United States source income.

f- "Residence"

The Congress Conference Committee decided that the term "*resident*"¹⁰⁶⁰ would be defined with reference to Section 911(d)(3) of the Internal Revenue Code which contains the definition of "*tax home*"¹⁰⁶¹. "*Tax home*" is defined as the individual's regular place. If the individual has more than one regular place, his or her principal place of business shall be considered his tax home or, failing this, his or her regular place of abode¹⁰⁶².

A United States citizen or resident alien will be accepted as a nonresident if he does not have a "tax home" in the United States. An individual shall not be treated as having a tax home in a foreign country for any period if his abode is in the United States¹⁰⁶³. The term "*abode*" is defined as one's home, habitation, residence, domicile or place of dwelling¹⁰⁶⁴.

When the individual's place of abode is in the United States and his principal place of business abroad the position is not clear. This is the result of such a complex system for the determination of residence.

¹⁰⁶⁰ IRC, Section 883(c).

¹⁰⁶¹ Zerbo, op. cit., p.238.

¹⁰⁶² Idem.

¹⁰⁶³ IRC, Section 911(d)(3).

¹⁰⁶⁴ Zerbo, op. cit., p.238; David Williams II: "Back to the Future: A Time for Rethinking the Test for Resident Alien Status Under the Income Tax Laws", *Vanderbilt Journal of Transnational Law*, Vol.21(1988), p.967.

g- Other terms

Some other related terms with international transportation have not been defined in the Internal Revenue Code, for example, "regularly scheduled transportation"¹⁰⁶⁵ and "United States trade or business"¹⁰⁶⁶. The term generally includes transportation of passengers or cargo. It is unclear whether tramp cargo is included or not¹⁰⁶⁷.

The latter is matter to be determined by the Courts¹⁰⁶⁸. However, the following factors may be relevant in determining if a foreign person is engaged in the conduct of a United States trade or business:

- 1- use of a United States office or other fixed place of business;
- 2- use of United States employees;
- 3- use of a resident agent or other legal representative and such person's power to contractually and legally bind the foreign person;
- 4- number, frequency and range of United States-based activities;
- 5- investment through a partnership or trust;
- 6- types of investments;
- 7- character of the activities¹⁰⁶⁹.

5- "To have a trade or business"

The problem is to determine the meaning of the term "to have a trade or business"¹⁰⁷⁰ since there is no definition of the term in the Internal Revenue Code or Regulations¹⁰⁷¹.

¹⁰⁶⁵ IRC, Section 887(b)(4)(B).

¹⁰⁶⁶ IRC, Section 887(b)(4).

¹⁰⁶⁷ Zerbo, op. cit., p.236.

¹⁰⁶⁸ Infra., p.268.

¹⁰⁶⁹ Stanton A. Kessler - Lawrence J. Zlatkin: "Foreign Investment in the United States: Planning Alternatives in Conducting or Acquiring a United States Business", *Bulletin for International Fiscal Documentation*, July/August-1991, p.374.

The following statement by Justice Blackmun in *Commissioner v. Groetzinger*¹⁰⁷² show that the term "trade or business" has a broad meaning:

"The phrase 'trade or business' is common in the United States Internal Revenue Code, for it appears in over 50 sections and 800 subsections and in hundreds of places in proposed and final income tax regulations. The slightly longer phrases, 'carrying on trade or business' and 'engaging in a trade or business' themselves are used no less than 60 times in the Code. The concept thus has a well-known and almost constant presence on our tax-law terrain. Despite this, the Code has never contained a definition of the words "trade or business" for general application, and no regulation has been issued expounding its meaning for all purposes. Neither has a broadly applicable authoritative judicial definition emerged..."

However, some activities noted in the Income Tax Regulations do not to constitute a United States trade or business¹⁰⁷³. For this reason, the only opportunity to find the meaning of the term, arises by examining the facts and circumstances in individual cases separately. At that point the consideration of the facts and circumstances by tax authorities could be stricter than that of the corporation's¹⁰⁷⁴, since it is the former that wants to increase the tax revenues.

Although there is no definition of the term "to have a trade or business", it is possible to gain assistance from other areas of legislation in the United States. For example, when a foreign corporation has an office or other fixed place of business to which such income is attributable it has a trade or business in the United States¹⁰⁷⁵.

¹⁰⁷⁰ Supra., p.241.

¹⁰⁷¹ IRC Regulations 1.864-4; IRC, Sections 871, 882 and 887.

¹⁰⁷² (1987), 94 L.Ed.2d 25.

¹⁰⁷³ See, IRC Regulations 1.864.

¹⁰⁷⁴ Christine Bouvier: "Foreign Corporations in United States Must Be Wary on Effectively Connected Income", *The Journal of International Taxation*, January/February 1992, p.289.

¹⁰⁷⁵ Supra., p.241.

An office or other fixed place of business shall include a factory, a store or other sales outlet, a workshop, or a mine, quarry, or other place of extraction of natural resources¹⁰⁷⁶. If a foreign corporation uses another person's office or other fixed place of business infrequently, it shall not be considered to have an office or other fixed place of business¹⁰⁷⁷.

Also, when a person merely controls the policies of a foreign corporation or supervises them, the foreign corporation shall not be considered to have an office or other fixed place of business. Management decisions alone do not constitute an office or fixed place of business in the United States¹⁰⁷⁸.

For example, when a domestic subsidiary corporation purchases goods from the foreign parent corporation the domestic subsidiary shall not be considered to be an agent of the foreign parent corporation, even if there is a relationship between them¹⁰⁷⁹.

However, if the domestic subsidiary corporation is doing some business on behalf of the foreign parent corporation such as regular negotiations and concluding contracts, or maintaining stock of merchandise and regularly filling orders, it is then treated as an agent of the foreign parent corporation.

When it is treated as an agent of the foreign corporation, it becomes a dependent agent and for this reason the domestic subsidiary office or other fixed places of business shall be treated as the office or other fixed place of business of the foreign corporation.

"Regularly" here means that there is some frequency over a continuous period of time¹⁰⁸⁰ which is based on the facts and circumstances in each case. But if the agent has a limited authority to negotiate and conclude contracts it shall not be considered as being regular.

¹⁰⁷⁶ Income Tax Regulation, 1.864-7-b(1).

¹⁰⁷⁷ Income Tax Regulation, 1.864-7-b(2).

¹⁰⁷⁸ Income Tax Regulation, 1.864-7-c.

¹⁰⁷⁹ Income Tax Regulation, 1.864-7-d.

¹⁰⁸⁰ Income Tax Regulation, 1.864-7-d(1)(ii).

The use of an "independent agent" does not constitute a trade or business. An independent agent is a general commission agent, broker, or other agent of an independent status acting in the ordinary course of his business in that capacity¹⁰⁸¹.

Some relevant factors in determining if a person is engaged in trade or business within the United States are the location of production activities, management distribution activities and such other functions.

Management activities are such as direction and control of the enterprise. Distribution activities can include storage of goods, solicitation of orders, advertising and promotion, clerical functions, showroom and samples and credit functions. Purchasing, financial activities, research, servicing of products, transportation and the like are examples of other business functions¹⁰⁸².

Furthermore, the type of business and the taxpayer's formal structure are other factors to determine if the taxpayer has a trade or business within the United States.

Although, most of the lists try to cover those activities which are within the context of the term "trade or business" it would also be possible to look at the negative side of the issue. For example, in the United States, as far as the Courts or Internal Revenue Service is concerned, trade or business does not exist in following cases¹⁰⁸³:

1- When a taxpayer has rented an office from a United States lawyer without obtaining exclusive use of any room or even a desk in the lawyer's office¹⁰⁸⁴;

2- When a taxpayer maintains a United States office to collect dividends¹⁰⁸⁵;

3- When a taxpayer advances money to a United States corporation for the purchase of ships, which are sold shortly thereafter¹⁰⁸⁶ (a single transaction);

¹⁰⁸¹ Income Tax Regulation, 1.864-7-d(2).

¹⁰⁸² Boris I. Bittker - James S. Eustice, *Federal Income Taxation of Corporations and Shareholders*, Warren Gorham Lamont-RIA, U.S.A. - 1994, p.15.28.

¹⁰⁸³ Joel D. Kuntz - Robert J. Peroni, *U.S. International Taxation*, Warren Gorham Lamont, Boston-1992, pp.C1-80.

¹⁰⁸⁴ *Recherches Industrielles*, SARISA, (1941) 45 BTA 253.

¹⁰⁸⁵ *Aktiebolaget Separator*, (1942), 317 U.S. 661.

4- When a taxpayer, after a whaling expedition, delivers whale oil to a buyer in the United States¹⁰⁸⁷.

The meaning of some terms similar to "to have a trade or business" are explained in *European Naval Stores Co. S.A.*¹⁰⁸⁸ in the United States as follows:

"The meaning of the three phrases ['engaged in business', 'carrying on business' and 'doing business'], either separately, or connectedly, convey the idea of progression, continuity, or sustained activity. 'Engaged in business means' occupied in business; employed in business. 'Carrying on business' does not mean the performance of a single disconnected business act. It means conducting, prosecuting, and continuing business by performing progressively all the acts normally incident thereto, and likewise the expression 'doing business', when employed as descriptive of an occupation, conveys the idea of business being done, not from time to time, but all the time..."

Exercising a trade has the same meaning as carrying on a business in *Gruinger & Son v. William Lane Gough*¹⁰⁸⁹.

One of the important objectives of the term "to have a trade or business" is the regularity. When a company has a trade or business, its transactions must be regular and continuous as expressed in *Commissioner v. Spermacet Whaling & Shipping Co.*¹⁰⁹⁰.

In *European Naval Stores Co. S.A.*¹⁰⁹¹ the important element "continuity" is identified as a component of the term "carrying on business". I think a single transaction or some small transactions do not indicate the existence of "continuity".

¹⁰⁸⁶ *Jorge Pasquel v. Commissioner*, 1953 T.C. 54.

¹⁰⁸⁷ *Commissioner v. Spermacet Whaling & Shipping Co.*, (1960), 281 F.2d 320.

¹⁰⁸⁸ (1948), 11 T.C. 127 in Richard L. Kaplan, *Federal Taxation of International Transactions - Principles, Planning and Policy*, West Publishing Co., St. Paul-Minnesota-1988, p.545.

¹⁰⁸⁹ (1896), 3 T.C. 462.

¹⁰⁹⁰ (1960), 281 F.2d 646; See David R. Tillinghast, *Tax Aspects of International Transactions*, Matthew Bender, New York-1978, p.281; Roger Royse - Michael Rashkin: "Effectively Connected Income in a Global Economy", *Tax Notes International*, 12.4.1993, p.926.

In *Linen Thread Co.*¹⁰⁹², a foreign corporation made two transactions with its resident agent in the United States. On one of the transactions, the Scotland-based company shipped an order to the resident agent for delivery and collection of the purchase price in the United States. In the other transaction, the company in Scotland shipped some goods to its subsidiary in the United States. The resident agent was involved in the paper work.

The court decided that the foreign company had a trade or business in the United States. It has been discussed that the continuity or sustained activity not exist in those two transactions because they were small isolated ones¹⁰⁹³. The important factor is to determine whether the transactions are small and isolated or not. In this case I agree with the court. A shipment of an order could not be a small transaction but a transaction. Since the transaction was made not once but twice, it could not be considered as a small or isolated transaction. It is therefore within the concept of the term "to have a trade or business".

6- Leasing Income

The United States' international double taxation agreements with other countries that grant equivalent exemptions for leasing income from the operation of ships and aircraft in international traffic are various. Some of the treaties exempt time or voyage charter, bareboat rental and container rental, but most of them exempt operating income at the same time¹⁰⁹⁴.

Different types of leasing exist such as bareboat charter, time charter and voyage charter.

A bareboat charter is a contract for the use of a vessel whereby the charterer performs functions normally performed by the owner of the vessel such as furnishing of

¹⁰⁹¹ (1948), 11 T.C. 127 in Richard L. Kaplan, *Federal Taxation of International Transactions - Principles, Planning and Policy*, West Publishing Co., St. Paul-Minnesota-1988, p.545.

¹⁰⁹² 14 T.C. 725 in *ibid.*, pp.545-546.

¹⁰⁹³ Kaplan, *op. cit.*, p.545.

¹⁰⁹⁴ For details see, The Revenue Ruling 89-42, 1989-1 C.B., p.234-237.

the crew and supplies and the charterer is in complete possession, control, and command of the vessel. The owner of the vessel bears none of the expense or responsibility of operation of vessel¹⁰⁹⁵.

A time charter is a contract for the use of the space in a vessel for a specified period of time. Under such charter the owner of the vessel remains in control over the navigation and management of the ship, paying and being responsible for the crew, supplies, repairs and maintenance, provisions, insurance, fees etc. The time charterer, on the other hand, is in control of where the vessel is to go, with what it is to be loaded, and is subject to charges for fuel, port charges, commissions, and expenses connected with the cargo¹⁰⁹⁶.

A voyage charter is similar to a time charter except that the vessel is chartered for a specified voyage instead of a specified period of time¹⁰⁹⁷.

Some examples can be given to illustrate the taxation of income from charter agreements in the United States¹⁰⁹⁸:

Example-1: X, a foreign corporation, is actively engaged within the United States in the leasing of bareboat charter vessels to others. During the taxable year it accrues income with respect to such leases. The foreign registry and equivalent exemption requirements of section 883¹⁰⁹⁹ of the Code are met.

Since X, which owns vessels is actively engaged only in the leasing of bareboat charter vessels to others it is not engaged in the shipping business. Accordingly, X is not entitled to exclude the income from such business under section 883 of the Code.

However, if X were to engage in the shipping business and occasionally lease out a vessel under a bareboat charter as an activity incidental to its shipping business, the profits from such lease may be considered shipping profits and excluded from gross income under section 883 of the Code.

¹⁰⁹⁵ The Revenue Ruling 74-170.

¹⁰⁹⁶ The Revenue Ruling 74-170.

¹⁰⁹⁷ Idem.

¹⁰⁹⁸ Idem.

¹⁰⁹⁹ Supra., p.245.

Example-2: Y, a foreign corporation, is actively engaged within the United States in the leasing of time charter and voyages charter vessels to others. During the taxable year it accrues income with respect to such leases. The foreign registry and equivalent exemption requirements of section 883 of the Code are met.

Since Y is actively engaged in the leasing of vessels to others under time charters and voyages charters, it is considered engaged in the shipping business and Y is entitled to exclude the income from such operations under section 883 of the Code.

Example-3: S, a time charterer of vessels, was incorporated in a foreign country by stockholders of a domestic corporation R. R is regularly engaged in business as a freight forwarder on behalf of a foreign government. During the taxable year, R entered into a contract with S for the shipment by S of cargo purchased by the foreign government from the United States government. An unrelated domestic corporation acting as agent for S time chartered vessels for the actual shipment of the cargo. The foreign registry and equivalent exemptions' requirements of section 883 of the Code are met.

Since S is a time charterer of vessels its profits from the operation of the vessels are considered shipping profits and S is entitled to exclude the income from such operations under section 883 of the Code. It is immaterial for the exclusion to apply whether S charters the vessels directly or through agents.

If S was a bareboat charterer of the vessels the situation will be as same as example 3 since a bareboat charterer of vessels is considered engaged in the shipping business.

Advice has been requested from the United States Internal Revenue Service as to whether charter hire income received from the leasing of a vessel is income from sources within or without the United States¹¹⁰⁰.

M was a domestic corporation and purchased a vessel. Later M leased it to R, an unrelated domestic ship operator, under a twenty-year bareboat charter. The vessel was documented in M's name under the law of the United States. R used the vessel primarily

¹¹⁰⁰ The Revenue Ruling 75-483.

in transporting property from Alaska to various points in the United States. The vessel frequently travelled outside the territorial waters of the United States as well. R was responsible for operating, maintaining, repairing, and insuring the vessel, and paying for all costs, taxes or other charges associated with ownership, use or operation of the vessel.

The Internal Revenue Service stated that, a charter hire paid to M by R for the charter of the vessel is, for Federal income purposes, income from sources within the United States to the extent allocable to (a) periods when the vessel is in a United States port between voyages, and (b) periods during which the vessel is engaged in a voyage that begins in a United States port and is travelling within the United States territorial waters. The charter hire allocable to periods when the vessel is travelling outside the United States territorial waters will be income from sources without the United States.

On 23.8.1994, the United States Internal Revenue Service issued a Letter Ruling¹¹⁰¹ about the exemption from the gross transportation tax under section 883(a)(2) of the Internal Revenue Code of 1986¹¹⁰². The Virgin Island incorporated sales corporation purchased certain aircraft and aircraft engines from a United States corporation that was engaged in the business of purchasing and leasing equipment including aircraft and aircraft engines in international transportation and then made a lease agreement. The lessee (the United States corporation) pays rent to the lessor (the Virgin Island corporation) pursuant to the lease agreements. The question is if this rental income was excluded in the lessor's gross income under section 883 of the Internal Revenue Code of the United States.

The gross income derived from leasing aircraft on a full or bareboat basis is exempted from federal income taxation if the foreign country grants an equivalent exemption to the United States corporations¹¹⁰³. If this income is exempted, a 4 per cent tax under section 887 does not apply.

¹¹⁰¹ The IRS Letter Ruling 9447024, 1994. Under "Letter Ruling", taxpayer applies to the tax administration to consult about possible tax problems of his future transactions.

¹¹⁰² Marjorie Rawls Roberts: "Letter Ruling Exempts United States Virgin Islands Foreign Sales Corporation From Transportation Tax", *Tax Notes International*, 13.3.1995, pp.904-906; James Fuller: "International Tax Developments", *Bulletin for International Fiscal Documentation*, July/August-1995, pp.335-336.

¹¹⁰³ IRC, Section 883(a)(2).

A foreign sales corporation cannot claim reciprocal exemption *by treaty* between the United States and a foreign country¹¹⁰⁴. In other words section 883 does not apply to the corporation. However, the Internal Revenue Service thinks that under the existence of reciprocal exemption *by statute* section 883 applies to the corporation. In fact, the United States Virgin Islands is treated as a foreign country for the purposes of section 883.

Also, a reciprocal tax exemption of income from international shipping and aviation between United States and United States Virgin Islands is based on statute and confirmed by exchange of letters on 12.7.1989 and 5.10.1989. For this reason, the corporation's income from the international operation of aircraft is exempted from federal income taxation¹¹⁰⁵ which imposes 4 per cent gross income tax on 50 per cent of all rental income sourcing from an aircraft flying to or from the United States.

The Internal Revenue Service stated in the same Letter Ruling that:

"...the purposes of section 927(e)(4) would appear to be implicated any time that a foreign sales corporation obtains a benefit, whether by statute or treaty, that reduces the federal income tax imposed on its non-exempt foreign trade income...section 927(e)(4) by its terms only applies where the taxpayer is claiming benefits under an income tax treaty."¹¹⁰⁶

7- Difficulties arising from the flag-of-convenience

The link between the ship and the flag state has been expressed by the International Law Commission in 1958 Geneva Conference on the Law of the Sea as follows:

"The essential corollary to the freedom of the seas must be that states exercise the same jurisdiction over ships sailing the high seas

¹¹⁰⁴ IRC, Section 927(e)(4).

¹¹⁰⁵ Roberts, op. cit., p.905; Fuller, op. cit., p.336.

¹¹⁰⁶ The IRS Letter Ruling 9447024, footnote-3.

under their flag as they exercise in their own territory. It is in this sense that ships are regarded as floating extensions of the flag state's territory.

This regime is based on the notions that the ship must in the main belong to nationals of the flag state; that the owners must be domiciled in that state; that the officers and at least the major part of the crew must be nationals of that state; that in foreign ports the consular officers of the flag state shall exercise the necessary control over such ships putting in at those ports, and, where appropriate, grant them such protection as they may need, and, finally, that the ships shall return to their home ports at regular intervals."¹¹⁰⁷

"*A flag country*" is the country in which the ship is registered or documented. The registration is fundamental in international transportation and the country of registration has jurisdiction over a ship and the conditions under which a ship is permitted to sail¹¹⁰⁸.

Many ship owners register their ships in "flag of convenience countries" (e.g. Liberia and Panama) in order to gain competitive advantages in the areas of taxation, operating costs¹¹⁰⁹ and lack of regulations. These countries offer exceptionally low taxation levels, only requiring that ship owners pay some expenses for registration, and/or official papers. Despite the fact that the shipping companies need not become residents, they receive all protection deriving from resident status¹¹¹⁰.

Despite the small amount of money charged for each ship the flag of convenience country can obtain high national income, depending on the size of the fleet of ships registered under the country's regulations. It is also an advantage for the ship owners that the flag of convenience countries are unlikely to demand eventual contributions to optional defence operating; if the ships are registered in the shipping

¹¹⁰⁷The United Nations Conference on the Law of the Sea (Geneva-1958) Official Records, UN.CLS.OR 4:34.

¹¹⁰⁸ Lambe, *op. cit.*, pp.118-119.

¹¹⁰⁹ See, *The Financial Times*, 9.11.1994, p.5.

¹¹¹⁰ Louis K. Tsiros: "Exemption of Transportation Income from U.S. Taxation: How Will Changes In the Tax Reform Act of 1986 Affect Foreign Corporations?", *Boston University International Law Journal*, Vol.7(1989), Part II, p.395.

company's own country, that country will normally be able to demand help in any national emergency from their ship-owning nationals.

Another advantage for ship owners is the cost of operating a ship. In many countries, shipping regulations exist concerning working conditions, wages for crew, the conditions of vessels etc., increasing the costs of operating the ship. However, the flag of convenience countries have neither the economic and political power nor finance to implement and enforce rules to control ship owners. The resulting lack of formalities and bureaucracy is a further advantage for the ship owners.

There are also disadvantages for ship owners if they register their ships under flag-of-convenience countries, in that they cannot get any benefits from their own governments. The flag-of-convenience countries also have more limited facilities in general than developed countries¹¹¹¹.

Those who are generally in favour of the use the idea of flags of convenience are ship owners, some employees and those who receive an income from the system. It may also includes tax officers who find their work reduced by the other country's tax officers. Even governments have some advantage in that they are able to compete with other nations under the same conditions.

The registration has a general acceptance for indication of that State's nationality under many international shipping Conventions. However, if the vessel has no registration, flag or related documents to indicate its nationality, it is still a possibility to possess a nationality of a state¹¹¹².

The International Transport Workers' Federation have drawn up the following list, which is not limited, of the countries and territories¹¹¹³ which are a flag-of-convenience: Antigua and Bermuda, Bahamas, Bermuda, Cayman Islands, Cyprus, Gibraltar, Honduras, Kerguelen, Lebanon, Liberia, Malta, Marshall Islands, Netherlands Antilles, Panama, St. Vincent and the Grenadines, Sri Lanka, Vanuatu.

¹¹¹¹ For advantages and disadvantages of flag of convenience country, see The OECD Study on Flags of Convenience (Hereinafter referred as OECD Study), *Journal of Maritime Law and Commerce*, Vol.4(1973), No.2, pp.243-248; Also see Tsiros, op. cit., pp.394-401.

¹¹¹² N.P. Ready, *Ship Registration*, Lloyd's of London Press Ltd., London-1991, pp.2-4.

¹¹¹³ Ibid., p.24.

One of the problem is the lack of clarity in the definition of a flag-of-convenience. Boczek has defined the term as "the flag of any country allowing the registration of foreign-owned and foreign-controlled vessels under conditions which, for whatever the reason, are convenient and opportune for the persons who are registering the vessels"¹¹¹⁴.

Some common features of the flag-of-convenience countries have been expressed as follows:

1- The country of registry allows ownership and/or control of its merchant vessels by non-citizens;

2- Access to the registry is easy. A ship may usually be registered at a consul's office abroad. Equally important, transfer from the registry at the owner's option is not restricted;

3- Taxes on the income from the ships are not levied locally or are low. A registry fee and an anual fee, based on tonnage, are normaly the only charges made. A guarantee or acceptable understanding regarding future freedom from taxation may also be given;

4- The country of registry is a small power with no national requirement under any foreseeable circumstances for all the shipping registered, but receipts from very small charges on a large tonnage may produce a substantial effect on its national income and balance of payments;

5- Manning of ships by non-nationals is freely permitted and for this reason there are lower crewing costs, since (a) registration under a flag of convenience generally means an unrestricted choise of crew in the international market, (b) absence of an onerous national wage scale;

¹¹¹⁴ Boczek, op. cit., p.2.

6- The country of registry has neither the power nor the administrative machinery effectively to impose any government or international regulations; nor has the country the wish or the power to control the companies themselves¹¹¹⁵.

The term "registration" is the entering of a matter in the public records¹¹¹⁶. The functions of registration are as follows:

- a- the allocation of a vessel to a specific State and its subjection to a single jurisdiction for the purposes, for example, of safety regulation, crewing and discipline on board;
- b- the conferment of the right to fly the national flag;
- c- the right to diplomatic protection and consular assistance by the flag State;
- d- the right to naval protection by the flag State;
- e- the right to engage in certain activities within the territorial waters of the flag State --for example, coastal fishing or trading between the ports of the flag State (cabotage);
- f- in case of war, for determining the application of the rules of war and neutrality to a vessel;
- g- the protection of the title of the registered owner;
- h- the protection of the title and the preservation of priorities between persons holding security interests over the vessel, such as mortgages¹¹¹⁷.

Flag-of-convenience countries do not impose high or any income or corporation taxes on profits from the operation of vessels under their flag except registration fees and annual taxes base on the tonnage of the vessel¹¹¹⁸. The absence of high tax is most important reason for the use of flags-of-convenience.

Taxing rights will normally be given to the country of registration under a double taxation agreement. This is necessary in order not to disadvantage the ships of a particular country. The problem lies with flag-of-convenience which leaves other

¹¹¹⁵ The Committee of Inquiry into Shipping, *Report*, HMSO, London-1970, p.51; Ready, op. cit., p.23.

¹¹¹⁶ Ready, op. cit., p.8.

¹¹¹⁷ Idem.

¹¹¹⁸ OECD Study, op. cit., p.243.

countries' ships at a comparative disadvantage. the problem can only be solved by concerted action by ship owning countries.

This has led some countries to offer special concessions to their own shipping operations at a national level.

According to the United Nations Conference on Trade and Development Secretariat Report¹¹¹⁹:

"...most of the traditional maritime countries allow shipowners various concessions...to defer or eliminate tax liability, which reduce the effective tax level, and in many cases are reported to result in an effective rate of zero...in Western Europe the concessions are believed to be particularly liberal, and shipowners who not only operate ships, but also buy and sell on a large scale do not appear to have any difficulty in minimizing their taxes to a low level or even avoiding taxes altogether."

8- Other Related Issues for International Transportation Companies

a- Branch Tax

The purpose of the branch tax is to equate the taxation of United States branches of foreign corporations with United States subsidiaries of foreign corporations¹¹²⁰. Two types of branch tax exist, branch tax on profits and branch tax on interest.

¹¹¹⁹ The United Nations Conference on Trade and Developments Secretariat, Action on the Question of Open Registries, 3.3.1981, TD/B/C.4/220 in Ready, op. cit., p.53.

¹¹²⁰ Blue Book, pp.1035-1047; James R. Mogle, *New Developments Affecting the Taxation of Foreign Investment in the United States*, The American Tax Institute in Europe, 16th Annual Congress, Cannes-France, 3-5.11.1993, p.8; See, The New York State Bar Association Tax Section: "The Branch Profits Tax - Report on Issues", *The International Tax Journal*, Vol.13(1987), No.4, pp.341-358; Norman Sternlicht: "Inequality After the Branch Profits Tax", *The International Tax Journal*, Vol.14(1988), No.3, pp.245-251; Aaron Rubenstein - Angela W.Y. Yu: "The Benefits and Burdens of the Final Branch Level Taxes Regulations", *The International Tax Journal*, Vol.20(1994), No.2, pp.58-92.

aa- Branch Tax on Profits

The Tax Reform Act 1986 imposed a 30% branch profits tax on foreign corporations' effectively connected earnings and profits¹¹²¹ in the United States after 1986 . A foreign corporation's branch income that is effectively connected or treated as effectively connected with United States trade or business is subject to regular corporate income tax, fixed at 34%. In addition to regular corporate income tax, a foreign corporation has to pay 30% branch profits tax for the rest of its income. Altogether the rate is 53.8%.

The branch profits tax is reduced or eliminated by income tax treaty if one of two conditions are met¹¹²²:

1- If the foreign corporation is a "qualified resident"¹¹²³ of the foreign treaty jurisdiction.

2- If the foreign corporation is not a qualified resident of the foreign country but the treaty allows a withholding tax on dividends paid by the foreign corporation.

"Qualified resident" has to satisfy three conditions:

1- 50 per cent or more of the value of its stock is owned either by individuals resident in the treaty country or by United States citizens or United States resident aliens, and

2- less than 50 per cent of its income is used to meet liabilities to persons who are not residents of either such treaty country or the United States

¹¹²¹ IRC, Sections 884(a) and 884(b); For details see, Richard M. Hammer - William D. Rohrer: "U.S. Branch Taxation: A Venture into the Unknown", *Bulletin for International Fiscal Documentation*, January-1987, pp.3-12.

¹¹²² IRC, Sections 884(e)(1), 884(e)(3) and 884(1)(3); Zerbo, op. cit., p.244.

¹¹²³ See Internal Revenue Service, Letter Rulings, LTR-9225017(1992), LTR-9225029(1992), LTR-9322021(1993) and LTR-9525030(1995) and infra., p.2.

3- its stock is primarily and regularly traded on an established securities market in its country of residence, or if it is a wholly-owned subsidiary of a publicly-traded company.

ab- Branch Tax on Interest

The Tax Reform Act 1986 also imposes a 30% tax on interest which is paid to foreign creditors by the foreign corporation's United States branch. This constitutes a kind of security: in the event that a foreign corporation deducts interest as an expense of its United States branch, the foreign recipient is subject to tax¹¹²⁴. But the existence of exemption between the foreign recipient and United States under an income tax treaty has an obstacle to tax the foreign corporations interest income. Also the result is the same for foreign corporation that they are "qualified resident" of treaty partners country¹¹²⁵. The definition of "qualified resident" is the same as in relation to the branch tax on profits.

b- Tax by withholding

A foreign corporation who is not engaged trade or business in the United States is liable to a 30 per cent tax by withholding which is imposed by article 881(a). Also deductions shall not be allowed under this section. 30 per cent tax by withholding applies only to the gross amount. This income will be fixed or determinable annual or periodical.

Important thing is the income should have been received from sources within the United States. If there is an agreement between two countries which includes an exemption for international transportation income the withholding rules does not apply¹¹²⁶.

¹¹²⁴ IRC, Sections 884(f)(1)(A) and 884(f)(1)(B); The United States Taxation Guide, International Tax Review Supplement, July-August 1994, p.55; Zerbo, op. cit., p.244.

¹¹²⁵ IRC, Sections 871 and 881.

¹¹²⁶ IRC, Sections 1441 and 1442; The United States Income Tax Regulations Sections 1.1441-1 --- 1.1441-4.

Withholding is made by the withholding agent. A withholding agent is "any person who pays or causes to be paid an item of income to (or to the agent of) a non-resident alien and who is required to withhold the tax" that in many cases it is a bank or other financial institution¹¹²⁷.

The tax by withholding will not apply if the person's United State source income is effectively connected with his business. In this case, normal income tax will be payable¹¹²⁸.

The rate of tax by withholding can be decreased by treaty. If 4 per cent gross basis tax and 30 per cent tax by withholding can both apply, only 4 per cent gross basis tax is applied¹¹²⁹.

c- Reporting Requirements and Penalties

Non-resident aliens or foreign corporations deriving United States source gross transportation income must file a United States tax return to pay 4 per cent gross basis tax or a full statutory or treaty exemption¹¹³⁰. It does not matter if no tax is due or if an exemption is claimed¹¹³¹.

Many transportation companies wrongly believe that they qualify automatically for an exemption as a result of a misunderstanding or a lack of information about

¹¹²⁷ Cherly Riedlinger, "US Withholding and Reporting Requirements for Non-resident Aliens", *Journal of International Banking Law*, Vol.7(1992), p.23.

¹¹²⁸ Riedlinger, op. cit., p.23.

¹¹²⁹ IRC, Section 883.

¹¹³⁰ The Revenue Procedure 91-12, Article 6.01.

¹¹³¹ Idem.

United States tax system. Foreign persons with leasing income from often consider they have no connection or income subject to United States tax.

However, the United States Income Tax Act had no any effective penalties for those who do not report that they are exempted from the United States tax, because under section 6651 of the Internal Revenue Code, the penalty for failure to file tax returns is zero¹¹³². Recently, some provisions have been adopted¹¹³³. Under new provisions, when a return is not filed a foreign taxpayer of operating ships in international traffic will lose the exemption. Also, they can not claim deductions or credits.

d- Cruise to nowhere

An interesting type of shipping transportation is a "cruise to nowhere" in the United States. A "cruise to nowhere" is a kind of voyage where the ship leaves a port to enter international waters and come back to the same port without stopping at any foreign ports¹¹³⁴.

The Internal Revenue Service held that the income was effectively connected with a United States trade or business and it was not subject to the United States source gross transportation tax and subject to tax under Section 882. Also, income earned from

¹¹³² Despite new reporting penalties have been offered, the offer has been rejected by the Ways and Means Committee on 27.7.1994. It is offered by William J. Jefferson and rejected after chairman Sam Gibbons said that, it fell perilously close to the so-called members bills and was only germane by the skin of its teeth in Kirchheimer, op. cit., p.419.

¹¹³³ Stanley S. Ruchelman: "Penalties for Shipping Company Non Filers", *Financial Times World Tax Report*, Vol.XXI (September-1996).

¹¹³⁴ Glen A. Stankee: "IRS Ruling Taxes All Income From 'Cruises To Nowhere'", *The Journal of International Taxation*, November-1994, p.511, footnote-1.

gambling --that was the main reason for the passengers to travel with cruises to nowhere-- restaurant and lounge activities, that are provided to the passengers by the operator, was directly related to the use of the vessel and was therefore transportation income¹¹³⁵.

e- Covered voyage

A "covered voyage" is a type of transportation¹¹³⁶ that includes (1) a commercial passenger vessel which extends over one or more nights, (2) a commercial vessel transporting passengers engaged in gambling aboard the vessel beyond the territorial waters of the United States (i.e., more than three miles from shore), during which passengers embark or disembark the vessel in the United States. The latter circumstance includes such vessels that leave a United States port and return the same day.

Despite the fact that this heading is related to excise tax which is not within the context of this thesis, some terms are related to international transportation and therefore, a brief explanation is given.

From 1.1.1990, the United States Senate Finance Committee imposed an excise tax of \$3 per passenger only once on a passenger's covered voyage -- either upon embarking or disembarking .

The excise tax does not apply to either (1) a voyage on any vessel owned or operated by the United States or a State or local government (e.g., State or local government ferry boats), or (2) a voyage of less than 12 hours between two United States ports. A passenger vessel is any vessel having a berth or stateroom accommodations for more than 16 passengers.

The Committee expanded the exemption to include certain ferry boat voyages of less than 12 hours between a port in the United States and a port outside the United States. For this purpose, the term "ferry boat" means any vessel if normally no more

¹¹³⁵ Ibid., p.511, footnote-6.

¹¹³⁶ The United States Senate Finance Committee, Revenue Act of 1992, H.R. 11, Technical Explanation and Bill, *United States Tax Reporter*, 6.8.1992, No.31 Extra, pp.421-422.

than 50 per cent of the passengers on any voyage of such vessel return to the port where such voyage began on the first return of such voyage to such port¹¹³⁷.

In *Royal Caribbean Cruises Ltd. v. United States*¹¹³⁸, transportation began in Vancouver, British Columbia, travelled along the Alaskan coast, and ended in Vancouver. Several brief stops were made at ports in Alaska without staying overnight and passengers were permitted to leave the ship for a short period.

Section 4471 of the United States Internal Revenue Code states that, a tax is imposed for each passenger on a covered voyage, either at the time of first embarkation or disembarkation in the United States. For this reason, the Internal Revenue Service interpreted the words "embark" and "disembark" as meaning the act of getting on or off a ship. The time that the passengers spent out of the ship is not important. If a passenger leaves the ship he is subject to the tax.

The company wished to interpret, the words "embark" and "disembark" as meaning "to commence" and "to end", and therefore, the passengers would not have been subject to tax, since the voyage began and ended in Canada. This interpretation was supported by Judge C. Clyde Atkins by reference to the dictionary, various cruise industry brochures and advertisements, and custom regulation. He mentioned that the court must solve the ambiguity in favour of the company.

¹¹³⁷ The United States Senate Finance Committee, Revenue Act of 1992, H.R. 11, Technical Explanation and Bill, *United States Tax Reporter*, 6.8.1992, No.31 Extra, pp.421-422.

¹¹³⁸ The United States News Digest, *Tax Notes International*, 17.7.1995, p.145.

CONCLUSION

Of the four sample countries, three of them - Canada, the United Kingdom and the United States - are developed countries with developed international transportation systems. Turkey is still developing and its transportation system is not as developed as the other three countries.

When we look at the tax system of three developed countries in terms of international transportation, we see that Canada and the United States have special legislation for international transportation but the United Kingdom does not. In the United Kingdom international transportation companies are treated simply as international companies.

It may be that the United Kingdom does not want to create a distinction between different types of businesses and attach a special importance to some of them such as international transportation companies.

Although one can say that it is difficult to justify countries or models¹¹³⁹ creating separate rules for international transportation, I think that special treatment for international transportation is necessary, given the increasingly international character of transportation¹¹⁴⁰.

Creating special rules for international transportation does not seem to be related to the development of the country, but may be the structure of Tax Acts. For example, the United Kingdom has a well developed transportation system but does not have special rules for international transportation. However, Turkey is a developing country but has special provisions for international transportation.

Although special rules are useful since they can deal with the problems which derive from the nature of business, still it is possible to see the same problems within general rules. For example, the definition of the terms "to carry on trade" and "branch

¹¹³⁹ *Supra.*, p.64.

¹¹⁴⁰ *Supra.*, p.92.

and agency"¹¹⁴¹ are quite important when making foreign companies subject to tax. However, these terms cause problems when they are applied both within the countries that have a special rules for international transportation such as Canada or the United States and the countries which have no special rules for international transportation companies such as the United Kingdom.

The reason is that these terms are open-textured and connected closely to the facts and circumstances which vary from case to case¹¹⁴².

Another term, "residence", is also problematic¹¹⁴³. To determine the meaning of residence all four sample countries use the incorporation rule. Besides the incorporation rule, Canada and the United Kingdom have a second criterion, the "central management and control". Turkey uses the "place of effective management" as the secondary test¹¹⁴⁴.

The "central management and control" test in Canada and the United Kingdom derives from the United Kingdom case law, *De Beers Consolidated Mines Limited v. Howe*¹¹⁴⁵. Lord Loreburn's words¹¹⁴⁶ have affected not only the United Kingdom's case law but also Canadian case law since the beginning of this century. Considering *Bedford Overseas Freighter Ltd. v. MNR.* in Canada, the term "central management and control" needs a clear approach. In that case, I think, the meaning of the term is broadened unnecessarily¹¹⁴⁷.

Some other terms such as "principal business", "principal purposes" and "primarily" are still not defined in the Canadian Income Tax Act, although they are interpreted by the Revenue Canada in interpretation bulletins¹¹⁴⁸. It would be much better for them to be included in the Income Tax Act in subsection 248(1).

¹¹⁴¹ *Infra.*, p.295.

¹¹⁴² Part-III.

¹¹⁴³ *Supra.*, p.203.

¹¹⁴⁴ *Supra.*, p.171.

¹¹⁴⁵ (1906), 5 T.C. 198.

¹¹⁴⁶ *Idem.*

¹¹⁴⁷ 70 D.T.C. 6072.

¹¹⁴⁸ *Supra.*, p.162.

Furthermore, income from bareboat charters should be subject to exemption in Canada. However, Revenue Canada regards those incomes as not being within the context of income earned from the operation of ship and aircraft.

Another problem area is the gross revenue test. The phrase "all or substantially all" in this test is interpreted by Revenue Canada to mean 90 per cent or more¹¹⁴⁹. However, in practice, there are problems in determining actual calculation. The percentage could be 89% and in that case as Judge Taylor stated "...the Minister might be hard-pressed to refuse a claim..."¹¹⁵⁰.

To calculate foreign companies' actual income and expenses cause problems because of the existence of different routes and price ranges. Therefore, the system which Turkey adopted seems practical as, under this system Turkey is taxing only a percentage of gross income rather than actual profits. The applicable rates for sea, air and land transport are 15 %, 5 % and 12 % respectively. This is the result of different profit margins for different types of transportation. However, despite the fact that the Turkish system is easy to apply, the differentials in rates might be regarded as somewhat arbitrary.

Pipeline transportation in Turkey is also problematic. Under the current tax system the income derived from the transportation of oil by pipeline from Turkish ports to a foreign port by foreign transportation companies is not subject to tax. The oil comes directly to the Turkish ports by pipeline and is stored in tanks and then loaded onto the foreign companies' ship. Under the Turkish-source income rule, if the beginning of the transportation of goods is in Turkey, this income should be treated as Turkish-source income and subject to corporation tax. Therefore, I cannot see any reason not to tax the income from pipeline transportation in Turkey.

In the United Kingdom, when non-resident companies carry on business without a branch or agency, the collection of tax is problematic since there is nobody to whom application can be made by the United Kingdom Revenue.

In the United States, although the 1986 Tax Reform Act has changed many parts of Internal Revenue Code as it applies to international transportation companies, still

¹¹⁴⁹ *Supra.*, p.162.

¹¹⁵⁰ *Idem.*

some terms need definition such as "regularly scheduled transportation" and "use" in the definition of transportation income.

Also, under new share based-residence tests or look-through rules in the United States, the foreign transportation companies will find it difficult to satisfy the new tests. In fact, the United States Internal Revenue wanted this new test since companies were too easily entitled to reciprocal exemption.

It is possible to say that the stance of United States disadvantages many countries since the United States has a well-developed transportation system and whenever they sign a reciprocal exemption with other countries which do not have a developed transportation system the agreement benefits the United States.

The signing of a reciprocal agreement would be more reasonable if all the agreements could be signed under the OECD, the United Nations or another model on which most countries were agreed certain principles or alternatives to protect the interest of all countries'.

Although the determination of 50 per cent rule is important, the timing of 50 per cent rule is not clear. The question is how long the shareholders must hold 50 per cent of the shares during a taxable year. The answer could be at least 90 per cent of the total days in a calendar year¹¹⁵¹.

Allocation of income is another problematic area. After the introduction of 50 per cent rule in the United States, for example, a round-the-world cruise which begins and ends in United States causes problems. Transportation companies want to keep the first and last legs of the cruise as short as possible to minimise the United States source income since the Joint Committee on Taxation states that only 50 per cent of the income from the first and last legs of the cruise would be considered United States source income. The same rules which apply to the other types of transportation, should apply to the round-trip travel companies.

In the United States, in connection with leasing, some problems occur. One question is which part of income from leasing and on-board service within the context

¹¹⁵¹ *Supra.*, p.250.

of United States transportation. Although some methods have been developed by the Internal Revenue Service, a clearer explanation would be preferable.

Another problem occurs in the United States, when related person is in charge for both on-board and off-board services since the rules governing the latter do not include the term related person¹¹⁵². It would be practical to add the term "related person" into the definition of off-board services.

The distinction between bareboat chartering and voyage or time chartering is clear in that one activity is investment, the other is transportation. Difficulties arise when a company is involved in a mixture of bareboat and voyage or time chartering. A simple solution is to say that when a company is a shipping company, all its charters should be treated as transportation income¹¹⁵³.

Another difficult problem to solve is finding the actual United States source income from the so-called cascading chain¹¹⁵⁴. It would be easy to solve the problem if only income from the first part of the chain were treated as United States source income. Otherwise, it is in practice impossible to find all possible further agreements between foreign parties. To expect to cover all the income from the cascading chain agreements is quite unrealistic regarding the increasing number of jurisdictions, taxpayers and activities.

Also, to determine whether a trade or business is being carried on within a country is also problematic in terms of different activities involved. A broad approach to the term would raise the national revenue because many foreign companies will be subject to tax. However, in the long term, companies may try to avoid coming within the meaning of the term and this would negatively affect investments in the country. For this reason, the examination of facts and circumstances is important and the courts should carefully check the intention of the company as to whether it intends to carry on business within the related country.

¹¹⁵² *Supra.*, p.255.

¹¹⁵³ *Supra.*, p.271.

¹¹⁵⁴ *Supra.*, p.248.

As seen, the term "to have a trade or business" or "carrying on trade or business" has a broad meaning. It is submitted that I agree with Brett L.J. who 116 years ago said in *H.G. Erichson v. W.H. Last*¹¹⁵⁵:

"It would be first of all nearly impossible and secondly wholly unwise to attempt to give an exhaustive definition of when a trade can be said to be exercised..."

However, some principles could be drawn out from the existing case law:

Continuity or regularity

It has been stated in many cases that when a company has a trade or business it should be continuous. Therefore, a single transaction or some small unrelated transactions would not constitute "trade or business". *Spermacet Whaling & Shipping*¹¹⁵⁶, *European Naval Stores*¹¹⁵⁷, *Marine Steam Turbine*¹¹⁵⁸ and *In re Griffin*¹¹⁵⁹ cases are examples of this principle.

An interesting point could be whether the very act of forming a company could be an indication of carrying on continuous business, because it is associated for carrying on business and the intention at the beginning was continuity. Although it seems difficult to say that company is carrying on business merely because it is formed with the intention of carrying on business, this was determined to be by the Court in *In re Alabama*¹¹⁶⁰ and *Smith*¹¹⁶¹. But an opposite view has been expressed in *Income Tax Case No.379*¹¹⁶².

¹¹⁵⁵ (1881) 4 T.C. 423.

¹¹⁵⁶ (1960) 281 F2d 320.

¹¹⁵⁷ (1948) 11. T.C.127

¹¹⁵⁸ (1919) 12 T.C. 124.

¹¹⁵⁹ 60 L.J.Q.B. 237.

¹¹⁶⁰ (1872) 1 Federal Cases 217.

¹¹⁶¹ (1880) 15 Ch.D. 147.

¹¹⁶² (1937) 9 S.A.T.C. 226.

In this case, the important point is whether a single transaction is enough to meet the criterion of having a trade or business. The existence of a single transaction has been deemed sufficient, for example in *Martin*¹¹⁶³, although there are many cases that look for more than one transaction.

In some cases a single transaction by the company could generate so much income that it need not trade for the rest of the year. For this reason, instead of examining how many transactions have been made, the size of the transaction should become a criterion. However, this is true only for a single transaction. When a transaction is repeated or becomes regular, the amount of income which the company involved produces ceases to be important.

Isolated transactions would not be within the concept of "to have a trade or business". To determine whether a transaction is isolated could be problematic. If the transaction is not directly related to the normal business of the company it could be an isolated transaction. In this case the facts related to each separate transaction must be evaluated. It is also necessary to find out how many transactions have been made by the company.

To make profit

This could be another criteria. The existence of a profit motive is an important factor as expressed in *Erichson*¹¹⁶⁴, *Moldovan*¹¹⁶⁵ and *Ransom*¹¹⁶⁶.

However, it has been stated in some cases that to make profit is not necessary. Also, buying itself is not sufficient to have a trade or business as in *Grainger & Son*¹¹⁶⁷.

¹¹⁶³ (1925) 11 T.C. 725.

¹¹⁶⁴ (1881) 4. T.C. 423.

¹¹⁶⁵ (1977) 77 D.T.C. 5213.

¹¹⁶⁶ (1974) 50 T.C. 88.

¹¹⁶⁷ (1896) 3 T.C. 481.

To make a contract

The existence of a contract would also be an indication for the company to have a business as expressed in *Crookston Brothers*¹¹⁶⁸, *Eccott*¹¹⁶⁹, *Muller*¹¹⁷⁰, *Nielsen*¹¹⁷¹, *E. and P. Gava*¹¹⁷².

However, even if a contract is not concluded within a country still the company may still have a trade or business in the same country as expressed in *Eccott*¹¹⁷³.

Some other factors such as place of delivery would also be an indication of having a trade or business as pointed out in *Thomas Turner*¹¹⁷⁴. Another factor could be the place of payment.

If there is a contract the problem arises as to where the contract has been made. If for example, a United Kingdom resident person, acting as an agent, telephones Canada to ask whether a Canadian person accepts the contract, when the Canadian person accepts, the contract would be treated as having been made in the United Kingdom. But when a Canadian person calls a British person to inform him that he accepts the contract, it is possible to say that the contract has been made in Canada. However, the Courts will then look for some other point such as place of payment or delivery.

Given the nature of recent technological developments in the field of international telecommunications it is extremely difficult to determine how and at what point a contract is concluded.

¹¹⁶⁸ (1910) 5 T.C. 602.

¹¹⁶⁹ (1926) 10 T.C. 481.

¹¹⁷⁰ (1957) 37 T.C. 505.

¹¹⁷¹ (1927) 13 T.C. 91.

¹¹⁷² (1926) 10 T.C. 698.

¹¹⁷³ (1926) 10 T.C. 481.

¹¹⁷⁴ (1898) 4 T.C. 698.

To have an agent

The existence of an agent would be another indication for the carrying on of trade or business. When a foreign company has an agent to arrange his business relationships with other people, it is possible to say that the foreign company is carrying on business as expressed in *Erichson*¹¹⁷⁵, *Werle & Co.*¹¹⁷⁶, *Pommery and Greno*¹¹⁷⁷ and *Firestone*¹¹⁷⁸.

When a foreign company has an agent the status of the agent becomes important because the agency may have an office in the country and the relationship between the agent and the foreign company could be an indication that there is a trade or business.

For example, when the agent becomes a dependent agent of the foreign company, the agent's office is treated as the foreign company's office, therefore, the foreign company is carrying on a trade or business in the country. This rule does not exist for independent agents.

When an agent is concluding contracts, attending negotiations and filling orders regularly, it becomes a dependent agency. The situation of the agent must be considered in each case separately.

The meaning of the term "to have a trade or business" has been subject to much research and case law. Despite all the attempts to make a list that could cover all activities that come within the concept of the term, it is impossible to cover them all. Perhaps that is the reason for tax authorities not to make an attempt to define the term, despite the term having very wide currency.

In today's world of extensive business relations one can say almost every activity intended to make money is a trade or business. Although there will be an increasing number of cases, it seems better to determine each case after examining the facts and

¹¹⁷⁵ (1881) 4 T.C. 423.

¹¹⁷⁶ (1888) 2 T.C. 402.

¹¹⁷⁷ (1886) 2 T.C. 182.

¹¹⁷⁸ (1957) 37 T.C. 111.

circumstances in the light of the above principles rather than attempts to define the term by listing activities.

The meaning of the term "residence" causes difficulties in the national law of many countries. It becomes more complex when the concept is dealt with in international law and especially when try to define or interpret the term "residence" in the absence of a proper definition or subsequent explanation.

When a company has residence in a certain country, it will be subject to tax by that country on its worldwide income. If it has no residence in that country only its income sourced in that country will be subject to tax. Since countries apply different tests to determine whether a company is resident, a company may be treated as having a residence in two or more countries and it would be subject to corporation tax in these different tax jurisdictions.

To determine whether a non-resident company is subject to tax in a given country it is important to establish the residency status of the company's operations within that country.

Since international transportation business is spread over different countries, many factors need to be assessed to determine the residence of a given company. For example, when its company's board of directors are resident in Country A and the owner of the company is resident in Country B, and both have power to control the company, then determining the residence of the company may be problematic.

The examination of the relationship and the division of power between the owner and the board of the directors may be complex, especially in large companies which have extensive business relations.

Dual residency is another problem for international transportation companies and that has become subject to several court decisions¹¹⁷⁹.

The place of incorporation seems a reasonable solution for dual residency since every company has just one place of incorporation. It would be effective if countries applied the place of incorporation to determine the residence of the company.

¹¹⁷⁹ Supra., p.213.

However, countries do not want to use only the incorporation test to determine the residence of companies. Companies may be incorporated anywhere and under the incorporation test, the country in which perhaps the bulk of the company's operations are carried out cannot tax that company.

In this case, many companies which have a business, for example, in the United Kingdom which will not be subject to tax in the United Kingdom if the United Kingdom applies only the incorporation test to determine company residence.

For this reason, some countries prefer to use two tests to make companies resident and subject to tax in that country. However, in this situation applying a secondary test, such as the "central management and control" test, can cause problems and sometimes causes dual residence.

Since international business is spread over many countries, frequently international corporations have several places of management for their companies. Sometimes, they carry on business in different countries but have just one place of incorporation. Using tests such as central management and control or effective management permits countries other than the country of incorporation to tax the corporation's income.

An international transportation company may have several people who carry on the company's management in different countries. In some cases it is relatively easy to find the real managing power of the company, when the company is run by a few people. To find the controlling power of the company the decisions about company policy or management must be considered. Their effects on the company business would indicate the effect of the orders but to carry on this research may take quite long time.

When different directors represent the company in various countries, to find the real managing power over the company's business relations is necessary in order to determine the residence of the company. However, the number of directors who take decisions for the company and their power can make the problem complex.

If the directors have equal or similar power one must examine the exercise of that power by each director to find the controlling power. If one director tends to

influence the general policy of the company more than that the other directors this director may have the controlling power. Otherwise, all other factors must be examined for the determination of the place of effective management or central management and control such as the use of this power on business relations and this may differ in each case.

Although in *Bedford Overseas Freighter*¹¹⁸⁰ the director of the company sent his orders from Greece, the company was found to be resident in Canada because the directors in Canada were doing all the activities of a board of management but in compliance with the orders they were given. In *Yamaska Steamship*¹¹⁸¹ a British agent was controlling everything from Britain but the directors of the company were resident in Canada and the company was found not to be resident in Canada. In these two cases the controlling power was exercised by a director and an agent both of whom were out of the relevant country.

In the first of the cases the Canadian directors of the company had no power over decisions and were simply following the orders of a Greek director. Therefore, there should not be any difference between the two cases. However, the Court decided differently in these two cases. It may be possible to say, in the first case, that central management was in Canada, because the board of directors was in Canada. However, the controlling power was abroad and the control was also effective over the management. I think that if control of the company is different from the place of management, the place of control should have priority.

Similarly in *Sifneos*¹¹⁸² the control of the company was with the principal of the Hadjilias & Co. and all instructions had been sent by him. However, the Court took the view that the directors of the company were the controlling power, because they were signing all documents and contracts and carrying on other important activities. In fact, the principal of the company who was controlling the company and his place of residence should have been the residence of the company.

The location where meetings of board of directors took place could be considered as a company's place of central management and control as in the *Calcutta*

¹¹⁸⁰ 70 D.T.C. 6072.

¹¹⁸¹ (1961) 61 D.T.C. 716.

¹¹⁸² (1968) 68 D.T.C. 522.

*Jute Mills*¹¹⁸³ and *De Beers*¹¹⁸⁴. In *De Beers* the company was even incorporated in South Africa. In *American Thread Company*¹¹⁸⁵ the company was also incorporated abroad but the board of directors were resident in England.

However, in *Attorney-General v. Alexander*¹¹⁸⁶ despite the company carrying on business in the United Kingdom, the Court found that its central management and control was in Turkey. A similar decision has been reached by the Court in *Denver Hotel*¹¹⁸⁷. Despite business being carried on in the United States and the company having a hotel manager there, the decisions were being made in the United Kingdom. The United States employee was following the United Kingdom directors' orders. Therefore, the company was resident in the United Kingdom.

The representative of a company can be a board of directors. If they receive orders from abroad it is not possible to say that the company is resident where the board is meeting as expressed in the *Aramayo*¹¹⁸⁸.

Although the controlling power is found important in many cases, having this power on paper and using it may be different. Lord Parker explained in the *Egyptian Hotels*¹¹⁸⁹ that to be seen to use this power is more important than actually having it. Despite it having been claimed that the real power was in the United Kingdom and that the power was also exercised, the Court found that the local board of directors exercised their power in Egypt. The directors in the United Kingdom had the power but did not exercise it in Egypt.

¹¹⁸³ (1876) 1 T.C. 83.

¹¹⁸⁴ (1906) A.C. 455.

¹¹⁸⁵ (1913) 6 T.C. 163.

¹¹⁸⁶ (1874) LR 10 Exch 20.

¹¹⁸⁷ (1895) 3 T.C. 356.

¹¹⁸⁸ Part-III.

¹¹⁸⁹ (1929) A.C. 1.

Interestingly, in the same case the House of Lords divided evenly and therefore the decision of the Court of Appeal was affirmed. The other view was that the United Kingdom directors had a controlling power and exercised this power.

Also registration could be an indication of carrying on business. However, it is not sufficient by itself and must be considered with other factors as expressed in *Swedish Central Railway*¹¹⁹⁰.

Sometimes companies can have two directors. One can be where they were incorporated and the other where they have trade or business. In that case it is important to find where the decisive power has. In *New Zealand Shipping Company v. Stephens*¹¹⁹¹ the Court found that all important decisions were made in the United Kingdom rather than in New Zealand.

When the controlling power is divided, the court should decide where the greater share of the power lies. In *Union Corporation*¹¹⁹² the Court found that the control in London was superior to that in South Africa.

As we have seen, in most cases the controlling power of the company is more important than the place of the board of directors. However, if they are in the same country it will not be a problem. When a person represent the company abroad or company has a board of directors, to find the location of controlling power is complex. The board of directors can exercise the controlling power which belongs to someone other than themselves. For this reason, to have a controlling power must be understood as exercising this power as well.

To find whether the controlling power is exercised within the relevant country the business relations of the company and relations between the board of directors in different countries must be examined.

¹¹⁹⁰ 1925 A.C. 495.

¹¹⁹¹ (1907) 5 t.C. 553.

¹¹⁹² (1951) 34 T.C. 207.

For dual residency, there are different solutions for different situations. If two countries have a double taxation agreement the problem of dual residency can be solved by a tie-breaker rule. If there is no tie-breaker rule in double taxation agreement the competent authorities of both countries can find a solution.

Also, when, for example, the place of effective management has been chosen as a tie-breaker rule, to find the place of effective management, countries can apply to the competent authority. Since the place of effective management is placed as a tie-breaker rule in the OECD and the United Nations Models, the competent authority becomes important in finding the place of effective management of the company under today's extensive business relations.

When dual residency occurs under national laws the problem becomes complex. If a company has dual residency in two countries because they apply two different tests such as "incorporation" and "central management and control" tests, bilateral negotiations between two countries would be a solution.

However, when two countries apply the same "central management and control" test, despite difficulties dual residency should not exist because it should be possible to find the controlling power. Because in most cases there is one controlling power. To eliminate dual residency, one must continue investigating the business relations of companies to establish where the real power resides. When two countries claim that real managing power is within their country, negotiations between two countries seems inevitable.

Countries must try to consider all the details concerning residency before signing a double taxation agreement. Otherwise, problems will occur at a later stage which causes wastage of time and creates confusion. This is true, not only for the company residence but for all the terms that have no definition in the field of international transportation.

The term "permanent establishment"¹¹⁹³ is a decisive factor to determine whether an international transportation company is subject to tax in a given country. If the international transportation company has, for example, an agent or an office for ticket sales it would be subject to tax in that country.

In terms of the meaning of the definition of permanent establishment deciding on which activities are within the concept can be problematic. Even the concept of some terms such as "an office" or "a factory", which are placed in many double taxation agreements, are not clear, even less so as to whether they constitute a permanent establishment.

Therefore, the Models and countries have attempted to list factors which will give rise to "permanent establishment". For example, Turkish Corporation Tax Act includes a list which is not comprehensive¹¹⁹⁴. Another way to solve the problem is to attempt to define situations which are not a permanent establishment.

However, the solution to the problem cannot be reduced to simple statements such as determining that "the company has a hut and, and for this reason it has a permanent establishment". The important point to be considered is the word "permanent". The length of time of the permanent establishment could be more easily considered if the phrase "lasting or intended to last for a long time or forever" replaced the word "permanent".

In practice, for example in Canada, the length of time for the existence of permanent establishment could be as short as three weeks. However, in the Models the time limit is generally accepted as 12 months, but it is still a time limitation.

If the countries cannot have consensus as to what time limit constitutes the concept of permanent establishment, a generally accepted time limit, such as 12 months, should be accepted by the countries. However, this 12 month period is not clear at all. In some cases it is a possibility that companies can cease operating working, for

¹¹⁹³ Supra., p.103.

¹¹⁹⁴ Supra., p.176.

example, every six months so not to be subject to tax and then coming back again to continue their work. In this case, they never complete a 12 month period and will not be subject to tax. An example of this could be a company working in the field of seasonal tourism.

Although one could say that it is difficult to move some establishments such as building sites, in some cases it is possible such as when a ship is used for exploration. However, in practice very short terms, as little as three weeks, have been accepted by the Courts to determine the existence of permanent establishments such as in *Fowler*¹¹⁹⁵.

When we consider an agent, it is also difficult to determine his status. Working with a dependent or independent agent may make a difference as to whether a company will be subject to tax or not. For this reason, the relationship between a company and an agent must be considered carefully examining all the facts and circumstances as the Court did in *Taisei*¹¹⁹⁶. Otherwise, it could be a way to escape for companies from tax in the relevant country.

The problem needs to be viewed from a wider angle to include all the structures and the intentions of the company in its conduct of business in the relevant country.

When the term is interpreted broadly the international transportation company could be subject to double or multiple taxation, because international transportation companies can have many permanent establishments such as an office in Canada, an agent in the United States or a warehouse in the United Kingdom.

For this reason, to eliminate this possibility which could prevent foreign companies from investing in that country, the tax authorities of both countries may try to solve the problem within the double taxation agreement. Otherwise it may happen that companies which do not intend to conduct business from a permanent establishment are deemed to do so by taxing authorities.

¹¹⁹⁵ 90 D.T.C. 1834.

¹¹⁹⁶ (1995) 104 T.C. 535.

GENERAL CONCLUSION

Developments in international taxation are rapid, mainly in response to the changing nature of international trade conducted by multinational corporations. Taxation is a sovereign issue imposed within a sovereign state and it is natural that conflicts will arise with enterprises that conduct business across the borders of the state. These conflicts are probably most apparent in international transportation which, by definition, is trade that is carried out between at least two sovereign states and under two tax jurisdictions.

Competition is a key element in international trade and as international trade becomes increasingly more competitive so will the quest for favourable tax regimes become increasingly vigorous. The improvement of international competitiveness one of the goals that all of the proposed tax systems must carry¹¹⁹⁷. Since international competition affects the level of national revenues negatively, national governments will tend to limit the tax rates and their expenditures¹¹⁹⁸.

When international transportation takes place in different jurisdictions regarding international competition, taxation of income from international transportation becomes, by its very nature¹¹⁹⁹, problematic since it is subject to dual or even multiple taxation and most international tax treaties are concerned with this problem.

The problem of finding the right jurisdiction to tax income from international transportation becomes complicated if a voyage includes several countries, or if the journey continues with different airlines. Also, when the tickets for different parts of the

¹¹⁹⁷ Alan Schenk: "VAT Debate Stimulated By Tax Reform Hearings In The United States", *VAT Monitor*, Vol.6(July/August 1995), No.4, p.204.

¹¹⁹⁸ As noted by Herbert Stein in Donald J.S. Brean: "Here or There? The Source and Residence Principles of International Taxation" in Richard M. Bird - Jack M. Mintz (ed.), *Taxation to 2000 and Beyond*, Canadian Tax Paper No.93, Canadian Tax Foundation, Toronto-1992, p.303.

¹¹⁹⁹ Trevor Carmichael: "Taxation and Transportation in Barbados: An Overview", *Bulletin for International Fiscal Documentation*, November-1992, p.551.

journey have been purchased in different countries or using different airlines for different part of the journey makes the situation worse. For this reason, the first priority is to locate the origin of income. After this one can decide whether the income is transportation income or income from activities which are not deemed transportation income.

Almost every country in the world has a different tax system even if they have similar economic and political structures. For example, within Europe, West European and East European countries have large cultural, social and economic differences. Therefore, solving the tax problems that are caused by the tax systems' diversity between two countries is difficult.

The existence of different tax systems in different countries is one of the reasons for the lack of a comprehensive multilateral treaty which would be an optimal solution. The harmonization of tax systems is difficult between two countries, but the difficulties are compounded when other countries are involved.

In terms of the lack of an effective multilateral treaty that covers all countries' benefits, in practice, bilateral agreements are preferred for the prevention of international double taxation in countries' double taxation agreements. For this reason, a very extensive and complex treaty network exists and increasing number of double taxation treaties make the situation worse. For example, when an international transportation company wants to engage in trade between various countries it must be aware of the existing double taxation agreements of each country. This includes all the problem areas of each double taxation agreement. Increasing number of problems deriving from double taxation agreements affect the international companies' business negatively. A company must review all of the different aspects of taxation before it can make its decision.

Certain multilateral treaties¹²⁰⁰ have not been successful because countries have had different economic structure. It is preferable for such agreements to be made by smaller economic or regional groups such as the European Union and NAFTA¹²⁰¹ or

¹²⁰⁰ *Supra.*, p.28.

¹²⁰¹ The North America Free Trade Association.

LAFTA¹²⁰² etc.. For example, the Scandinavian countries have successfully concluded a multilateral treaty, the Nordic Convention¹²⁰³. Since they are in the same group and they have similar economic interests, it would be easier for them to agree on certain problem areas. This may be a first step towards a multilateral tax treaty.

Despite the fact that the OECD and the United Nations Model Treaties are very effective guides in the field of international taxation, especially for the prevention of international double taxation, bilateral tax treaties tend to give an advantage to some countries, especially to developed countries. Small or developing countries have little power in international tax arenas to defend their interests as compared to the other treaty partners which have much more economic and political power.

The general acceptance of the residence or effective management principle gives an advantage to developed countries to tax income of international transportation companies since developed countries have a well-developed transportation fleet. Although developing countries' ports are used by developed countries' transportation companies, incomes from international transportation are generally taxed by developed countries. They also use cheap labour and facilities, also increase their national revenues and this situation seems not fair. However, it is possible to say notwithstanding developed countries' right to tax, developing countries still have some benefit from international transportation business as it helps to develop their country via investment, collecting some local taxes, labour movements etc..

Under a multilateral tax treaty, for example, the use of the source principle to tax international transportation business helps developing countries to increase their national revenues. Although this result seems fair, it is difficult to persuade developed countries to use the source principle instead of the residence principle. Otherwise, developing countries can not join the international competition and not increase their national revenues. However, even a multilateral treaty between developed countries can reduce some problems deriving from international transportation that are explained in this thesis.

¹²⁰² The Latin America Free Trade Association. For a detailed comparison between the OECD Model, the Andean Pact Model and Lafta Drafts see, Ramon Valdes Costa: "CIAT Conference-1977", *Bulletin for International Fiscal Documentation*, Vol.31(1977), pp.13-23 (CIAT=Centro Interamericano de Administradores Tributarios - The Inter-American Center of Tax Administrators).

¹²⁰³ *Supra.*, p.31.

Although reciprocal exemption seems quite appropriate since the transportation income is simply exempted in one country, the effectiveness of the rule depends on some facts such as how close the relationship of two signatory countries or their economic power. If one of the signatory countries has a more developed transportation system than the other, signing reciprocal exemption agreement is an advantage for it since the other signatory country's transportation system is not well developed. Under these circumstances the country with a less developed transportation system will lose revenue by not taxing the other country's transportation income.

The system works when two signatory countries have the same or similar transportation systems. This means, when they make an agreement and exempt certain transportation income from tax in their own country, their gain or loss from the taxation of transportation income makes no big difference.

The acceptance of different principles, for the determination of tax jurisdiction such as a residence, source or effective management, between different countries is a serious obstacle to make a uniform solution in the field of international taxation. Although the adoption of a principle would solve the problem which is exactly the idea behind double taxation agreements, this may cause problems when there is a clash of national interests.

For bilateral tax treaties the solution could be to propose alternative articles on certain types of income such as Article 8A and 8B in the United Nations Model. Although it is difficult to say whether it would work properly if it was extended to cover all forms of transportation, the system could be a model for the future.

A multilateral tax treaty would be a much neater solution than the proliferation of bilateral tax treaties which exists today. A multilateral treaty could prevent this conflict and make uniformity between different principles. Like the OECD did in recent years, several working groups can study certain double taxation problems for the development of the Model to make necessary amendments. A multilateral tax treaty must provide answers for the needs of both developed and developing countries including options on each article, encouraging countries to adopt the same model. Instead of trying to establish a new multilateral tax treaty which tries to cover the national interests of all the countries, the OECD or the United Nations Model could be chosen as a basis for or even adopted in its entirety as a multilateral tax treaty.

When trying to establish a multilateral tax treaty it would be helpful to organise "model tax problems" units in each signatory country. These units will collect all the information regarding tax problems and, if possible, elaborate solutions and send these to the central unit to compare and exchange information. Then permanent working groups could study the problems and produce solutions.

Also, in this central unit, a committee could be established to decide conflicts. This committee should not be a court, since lengthy legal presentations would prolong resolutions, but a kind of advisory board composed of tax experts of different countries. When an international problem occurs countries could ask advice from this committee for possible solutions.

The choice of principle seems to be a political expedient but the problem of defining or interpreting the principles is often a legal problem. For example, many different courts have ruled on the meaning of "residence". The effective management principle has the problem of determining the meaning of the term "effective" and differentiating it from other places of management. Sometimes it is possible to see that the extension of the concept goes far beyond existing possible meanings, as in *Bedford Overseas Freighters Ltd. v. M.N.R.*¹²⁰⁴. Such an expansive interpretation may cause economic difficulties in the future, as expressed by the Transportation Task Force Asia-Pacific Initiative Advisory Committee.

The real problem is to find the place of "central management and control" or the place of "effective management". Since countries use these tests to determine the residence of the foreign company, when it is not clear what kind of management is effective the business relations of the company must be considered. Furthermore, central management and control can be in different places. If the control of the company is within the place of central management then it can be solved easily. However, if the controlling power and the place of effective management are in different places, the problem becomes complex. Therefore, the business relations of the company and the use of controlling power between directors must be examined in each case¹²⁰⁵.

¹²⁰⁴ (1970) 70 D.T.C. 6072.

¹²⁰⁵ *Supra.*, p.298.

In some cases it is even difficult to find the controlling power. Also in some cases it has been mentioned that to have the controlling power is not the same as to use the controlling power. In this situation, again, the external and internal relations of the company are important. Although it is relatively easy to find the controlling power within small companies, it is difficult for large or multinational companies in terms of their worldwide business relations and existence of different places of management in many countries. Since the incorporation rule is not the only rule to determine the residence of companies in the world it seems inevitable that the countries must apply other tests.

Another difficulty related to international transportation concerns certain definitions. The first and most important one is the meaning of international transportation. In the international area and especially in the OECD and the United Nations Models the term causes difficulty¹²⁰⁶. For example, many types of vessel can be considered "ships" or "aircraft". A detailed list would be helpful for both transportation companies and tax authorities but it should not be overly restrictive as technical developments are constantly producing new types of transportation vehicles. Otherwise, every new type of vessel which is involved in transportation may lead to confusion in practice.

Also, despite the heading of Article 8 of the OECD and the United Nations Models being "shipping, inland waterways transport and air transport", only "ship", "boat" and "aircraft" have been used in the context of Article 8. Although the term "aircraft" seems suitable to the heading, the term "ship" and "boat" should not be the only vehicles mentioned for shipping and inland waterways transport. Since shipping and inland waterways transport could include all types of vessel on water the heading and the context of Article 8 do not follow each other. For this reason, some necessary changes should be made¹²⁰⁷.

The meaning of the term "income from international transportation" is also problematic since the existence of many ancillary activities are so numerous as to make it difficult to list. Principles should be evolved so as to offer a basis on which decisions can be made. Such a broad principle could be those activities which are included in the ticket price should be considered an intrinsic part of the transportation. Also, some

¹²⁰⁶ *Supra.*, p.92.

¹²⁰⁷ *Supra.*, p.96.

services which the transportation company offers during transportation would be within the context of international transportation, if the transportation company performed them itself.

Also, the term "permanent establishment" causes difficulties since many countries have given a different meaning to the term in order to increase their revenues. The main source of the confusion was the attempt of various revenue services to broaden the concept to increase tax revenues. For this reason, even the existence of a plot of land has been found sufficient for the existence of permanent establishment¹²⁰⁸. One would expect that there should be at least a primitive building on the land capable of being used as an office, even if it were unmanned, before permanency could be established.

Even if countries agree on a list of which activities constitute permanent establishment they can still be subject to tax in different countries because they may have many permanent establishments. For example, if a transportation company has an office in Turkey and an agent in the United Kingdom it would be subject to tax in both countries. In this context a double taxation agreement resolves the problem. Furthermore, the time period for the existence of permanent establishment needs explanation. Although the 12 months period is adopted by the Models for some activities, in practice the Courts reduce the time limit to broaden the concept of permanency.

Giving a wider meaning to the term "permanent establishment" could increase the ability of developing countries to increase their revenues. The foreign companies' point at which business is conducted within the country can be interpreted as a permanent establishment. However, in practice the term has quite a large scope and many countries attempts are made to give it even a wider meaning to increase their revenues,

Another problem area is to find whether a company is "carrying on a business". Although it is difficult to make a list of all activities could be included by the term, some principles may be used such as continuity or regularity, to make profit, to make contract and to have an agent¹²⁰⁹. However, for example, the existence of a contract may be an

¹²⁰⁸ *Supra.*, p.106.

¹²⁰⁹ *Supra.*, pp.292-295.

indication for the term carrying on business but establishing the point at which the contract has been made can be problematic. Sometimes a telephone conversation could be sufficient to complete the contract. In this case we still have the problem of deciding where the contract has been made. An international telephone call raises the question of in which country the verbal contract has been made. Determining the place where the contract has been made is extremely difficult by the existence of a well-developed international telecommunication systems.

Therefore, to examine all the facts and circumstances in each case seems the best solution under the principles mentioned above.

Also, flags-of-convenience are used by many companies to avoid taxation. Many countries are happy to allow their shipping to go under these flags so that their shipping remains competitive in the international marketplace. However, tax revenue is lost. A solution would be for pressure to be brought on all countries to avoid flags-of-convenience. This however could only be done if there was an element of harmonization in tax law and tax rates among the participating countries, in other words a multilateral treaty. Until this happens flags-of-convenience will remain a feature of international shipping.

As a result, international transportation has many problems to solve. The solution depends upon the will of countries to find appropriate and radical solutions. When countries are agreed on a new multilateral treaty or on one of the existing models that are suitable for all countries as a multilateral treaty and provide different alternatives the problems may be solved. At least, they could concentrate on improving the system of data collection and information sharing. Otherwise, the natural desire of all countries to maintain their sovereignty, especially on the issue of taxation, will continue to cause problems.

International transportation is ever expanding and with the increase of passenger mileage and cargo tonnage year upon year, it becomes increasingly important for countries to find agreement among themselves as to how to tax it. One looks forward to greater harmonisation of the rules and general acceptance of definitions and this could be within the frame of a multilateral tax treaty. Otherwise, courts are under pressure in terms of increasing number of cases which is a result of extensive international business relations. As Lord Denning has noted concerning the proliferation of court cases:

"...Thousands upon thousands of cases. The volumes increase year by year. I sometimes wonder whether our system of case law will stand the strain..."¹²¹⁰

Extensive co-operation between countries towards a multilateral treaty will reduce problems in the field of taxation of international transportation income.

¹²¹⁰ Lord Denning, *Landmarks in the Law*, Butterworths, London-1984, p.369.

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